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SOCIAL SECURITY: CONTINUING CRISIS OR REAL REFORM?

INTRODUCTION

> Despite the rhetoric to the contrary, the Social Security Amendments of 1983 did little more than give us a brief respite from the task of redesigning Social Security so that it will meet the needs of our citizens in a way that is consistent with our financial capacity to satisfy those needs. We should not be surprised, therefore, when the Social Security issue becomes prominent again in the months ahead.
>
> —A. Haeworth Robertson[1]

The opposition of the elderly to benefit cuts and the discontent of younger workers over the prospect of declining (or even negative) returns on their Social Security taxes are bound to create an increasing amount of intergenerational conflict. A realistic appraisal of the structural problems inherent in the Social Security system is necessary if meaningful reform is to be achieved and the intergenerational conflict resolved.

Although the 1983 Social Security Amendments (P.L. 98-21) largely corrected the short-run financing problem in the Old-Age, Survivors, and Disability Insurance (OASDI) programs, the long-run health of these programs depends heavily on assumptions that may prove far too optimistic. A rekindling of inflation together with an economic downturn later in the decade could sharply upset the fragile balance between receipts and outlays for OASDI, and could generate yet another Social Security crisis.[2]

Other problems also plague the Social Security system: There is a conflict between the welfare and insurance components of the

[1]"Have the Social Security Problems Been Resolved?" *The Mercer Bulletin* 9 (September 1983): 2.

[2]See Peter J. Ferrara, "Social Security: The Crisis Draws Closer," *The Political Economy in Perspective,* H. C. Wainwright & Co. Economics, May 9, 1983, p. 9.

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system;[3] the insurance component remains unfunded and subject to political manipulation; and the actuarial deficit in the Hospital Insurance (HI) portion of Medicare remains enormous—averaging 3.90 percent of taxable payroll over the period 1983 to 2057.[4]

The ability of Congress to immediately increase Social Security benefits for retired workers while delaying payroll-tax increases, along with its power to repeat this sequence for each generation, is an important reason why Social Security has gained widespread popularity, especially among the retired and those near retirement. Nevertheless, as the system matures and real returns decline, the true nature of the pay-as-you-go system—which has been characterized as a chain-letter scheme—will become evident. Fundamental reform, such as privatizing OASDI, may then become feasible. Indeed, since younger workers could face payroll tax rates of up to 40 percent by the middle of the next century and may not begin receiving benefits until age 67 or 70, they might well prefer a private alternative that would give them a greater and more certain return on their contributions, as well as more flexibility over the timing of retirement.[5]

In order to consider the full range of reform proposals, the Cato Institute invited many of the nation's leading experts on Social Security to a two-day conference in Washington, D.C., June 6 and 7, 1983. The edited papers from that conference, along with A. Haeworth Robertson's congressional testimony on the National Commission's recommendations for Social Security reform, constitute this issue of the *Cato Journal*. The papers cover four main areas: the political economy of the Social Security system; options for reforming the system; the economic effects of Social Security; and strategy for dealing with the implementation problems associated with denationalizing OASDI. The following conclusions are noteworthy.

1. In analyzing Social Security, it is essential to consider the effects of property rights on incentives and individual behavior. The theory of public choice helps explain why the system has grown

[3]See Ferrara, *Social Security: The Inherent Contradiction* (San Francisco: Cato Institute, 1980).

[4]Estimated from data contained in the 1983 Annual Report of the Board of Trustees for OASDI (pp. 100, 121). In order to eliminate the HI deficit, taxes would have to be increased, on average, by 3.90 percent of taxable payroll over the next 75 years. For a further explanation of actuarial deficits, see A. Haeworth Robertson, *The Coming Revolution in Social Security* (McLean, Va.: Security Press, 1981), chap. 7.

[5]The 40-percent payroll-tax estimate is provided by Robertson, in "Have the Social Security Problems Been Resolved?," p. 1. Robertson also states, "It is entirely reasonable for today's youth to anticipate further increases [in the retirement age] to age 70 or higher." Ibid., p. 2.

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and why the public has resisted a more voluntary system of retirement insurance.

2. Social Security is ultimately a manifestation of the welfare state. Real reform, therefore, may require constitutional change that effectively limits the taxing and spending powers of government.
3. Advocates of real reform suggest, as the first step, separating the welfare and insurance components of the system. The insurance component could then be privatized and placed on a fully funded basis—an impossibility under government ownership and control. The private retirement system could also be made voluntary. Such a system would place responsibility on individual decision-makers and efficiently utilize existing knowledge to generate the best use of private savings. It would also reduce the encroachment on private property rights and strengthen freedom of contract.
4. Specific criteria should be considered in reforming the Social Security system. The system should foster economic efficiency (i.e., it should not distort economic behavior); sunk costs should be explicitly recognized and not be allowed to deter meaningful reform; the system should be free of political influences; and the system should be flexible, easily understood, and consistent with the principles of a free society. Adhering to these criteria will ensure the financial soundness of the system while promoting individual freedom and responsibility.
5. The existing pay-as-you-go system interferes with individual choice and distorts economic behavior in three ways. First, the system attenuates the freedom of workers to determine the optimal mix of savings and consumption for themselves (or the time path that they desire for consumption). Workers are forced to pay Social Security taxes—to redistribute income to the elderly—with the promise of future Social Security benefits. This process tends to depress private savings and investment.[6] Second, Social Security interferes with the freedom of workers to determine the timing of retirement. The earnings test and other features of the system induce workers to retire earlier than they would in the absence of Social Security. Third, the payroll tax artificially increases the

[6]For a further discussion of the adverse effects of Social Security on private savings, see Carolyn L. Weaver, *The Crisis in Social Security: Economic and Political Origins* (Durham, N.C.: Duke University Press, 1982), pp. 185–87; and Roland Vaubel, "Reforming Social Security for Old Age," in Herbert Giersch, ed., *Reassessing the Role of Government in the Mixed Economy* (Kiel, W. Germany: Institut für Weltwirtschaft an der Universität Kiel, 1982), pp. 180–82.

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price of labor in relation to capital, causing a misallocation of resources.[7]

6. Social Security affects both the intragenerational and intergenerational distribution of income. The 1983 amendments continue to redistribute income from high-income to low-income earners, from single persons to married couples, and from younger workers to the elderly retired. Most significant, the 1983 law imposes losses on all Social Security participants, with the greatest burden falling on the younger generation of workers.
7. The political barriers to privatizing the insurance component of Social Security are formidable, but not insurmountable. As the experience of Britain and other countries has demonstrated, it may be possible to move toward a system in which workers could allocate part of their payroll taxes to IRA-type investment accounts. This proportion could be increased over time until the transition to a private retirement system is complete.

This issue of the *Cato Journal* should provide a useful reference for all those interested in developing an old-age insurance system that would be more equitable and financially secure than the existing system. Further research, however, needs to be conducted on the economic effects of Social Security and on the political economy of privatization. We must also address the question of whether individuals have a right to social welfare and insurance. To answer this question, it will be necessary to go beyond economics and construct a consistent theory of rights.[8] Developing such a theory could have a significant impact on the intellectual support for Social Security and could ultimately influence policy.

J. A. Dorn
Editor

[7]An interesting discussion of the effects of Social Security on the labor-supply decision is found in Vaubel, pp. 180, 182.

[8]See Roger Pilon's interesting work on this subject, especially the articles he cites in this issue of the *Cato Journal*.

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SOCIAL SECURITY SURVIVAL: A PUBLIC-CHOICE PERSPECTIVE

James M. Buchanan

I. Introduction

Economists are professionally trained to search out and to discover alleged inefficiencies in institutional arrangements, public and/or private. Further, once alleged inefficiencies are located, economists have an impulsive proclivity to propose reform. I am no different from my peers in these respects; on several occasions, I have joined the ranks of those who have advanced proposals for reform in the Social Security system.[1] As I have emphasized in earlier papers, however, the task of designing reforms that meet the test for Pareto superiority, even when considerations of practicability are totally neglected, is by no means an easy one. But, of course, unless some such reforms can be demonstrated to be possible, the existing system must be judged to be Pareto efficient. Note carefully what such a judgment would and would not imply. It would not imply that everyone could not have been made better off by a series of different decisions made over a historical sequence of periods. Clearly, we could all be in an improved position today if Americans, privately and collectively, had invested more in capital formation in the 1950s, 1960s, and 1970s. And the incurrence of "social insurance" debt, even if implicit, without the creation of offsetting assets, is the same

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The author is university professor of economics and general director of the Center for Study of Public Choice, George Mason University, Fairfax, Va. 22030.

The author is indebted to his colleagues Geoffrey Brennan, Loren Lomasky, Jonathan Pincus, and Gordon Tullock for helpful comments.

[1]See Buchanan, "Social Insurance in a Growing Economy: A Proposal for Radical Reform," *National Tax Journal* 21 (December 1968): 386–95; "Comment on Browning's Paper," in *Financing Social Security*, ed. Colin Campbell (Washington, D.C.: American Enterprise Institute, 1979), pp. 208–12; and "Dismantling the Welfare State," paper presented at the regional meeting of the Mont Pèlerin Society, Stockholm, Sweden, September 1981.

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thing as negative capital formation. But to regret the loss of what might have been if a different series of decisions had been made is not to say that there must be inefficiencies in the set of institutional arrangements that is now in existence. Nor would a judgment that the existing institutional structure is Pareto efficient imply that it satisfies criteria of equity or justice. The intergenerational transfer may be widely held to be grossly inequitable although it meets the test for Pareto efficiency.

So much for preliminaries, which I advance here for two purposes: to indicate what I shall not discuss in this paper, and to provide background for what I shall discuss. I want to resist the temptation to analyze proposals for structural reform, whether they are my own or those advanced by others. Aside from a slight departure in section X, I shall remain within predictive public-choice theory, and I shall attempt to explain public-choice aspects of the existing Social Security system that the economists-as-reformers have often found puzzling. Specifically, I want to explain the *survival* of what seems to be neither a viable intergenerational social insurance system nor an efficient welfare system. Why does what seems to be an *n*-person, *n*-period social dilemma have such staying power?

II. The Sacred and the Profane

I commence with a simple empirical observation. Elected politicians, at all levels, treat the existing system as sacrosanct. It is widely presumed that any pronounced challenge to the basic structure of the system is equivalent to political suicide. The "reforms" that have been proposed and/or implemented are widely acknowledged to be temporary patches on the rips around the edges of the structure. There is no apparent support for basic institutional change.

If these politicians, over all persuasions and in all parties, are to be credited with ordinary precepts of rational behavior, the implication seems clear. There is no widespread support for basic structural reform, among *any* membership group in the American political constituency—among the old or the young, the black, the brown, or the white, the female or the male, the rich or the poor, the Frost Belt or the Sun Belt. The absence of support for structural change among the old, the disabled, the low-wage earners, and possibly some other constituencies, requires no sophisticated explanation. For these groups, self-interest considerations are sufficient. But why is there not more opposition to the system observed among the ranks of the young? Why is the support for the system so universal?

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Why do young and even prospective employees support the system when plausible computations of the expected rates of return to "investment" within the system suggest that these rates may be significantly lower than rates of return on comparable investment in individually purchased, privately marketed retirement-disability schemes? Must we finally explain the absence of even so much as nascent opposition among the ranks of the young by resorting to the naive belief that the Ponzi scheme is never-ending? Must we blame failures of information and communication, illusions, altruistic impulses, and rational ignorance? Or are there rationally derived reasons for the near-universal support[2] for the system—reasons that have somehow been overlooked by most economist-critics?[3]

III. Comparison of Relevant Alternatives

To begin to answer these questions, it is best to begin with a skeletal summary of the existing system. It is an unfunded transfer scheme that imposes payroll taxes on currently employed persons and utilizes the revenues from such taxes to finance payments to qualified nonemployed recipients (retirees, dependents, survivors, and the disabled). The system is not, however, a simple interclass transfer mechanism operated on in-period differentiation between qualified taxpayers and qualified recipients. Eligibility claims for benefit payments are established by an employment record, applicable over all classes and wage levels of covered employees, rather than by direct means-test criteria. Through their own payroll records, employees accumulate claims against the system—claims that must be met in accordance with designated criteria for eligibility.

Financially, the system as a whole is best understood as an unfunded liability of the national government, an implicit, indexed national

[2]By "rationally derived," I mean in line with the demonstrated self-interest of participants, strictly in keeping with public-choice orthodoxy. I shall, in this paper, ignore the whole set of problems introduced by the absence of individual *responsibility* for political decisions in democracy, and the effects of this absence on precepts for individual rationality in the specific acts of expressing political "choices." On these problems, see Geoffrey Brennan and James Buchanan, "The Logic of the Levers: The Pure Theory of Electoral Preference," mimeographed (Center for Study of Public Choice, Blacksburg, Va., January 1983); and Geoffrey Brennan and Loren Lomasky, "Large Numbers, Small Costs: The Uneasy Foundations of Democratic Rule," mimeographed (Center for Study of Public Choice, Blacksburg, Va., March 1983).

[3]It may, of course, be argued that the prevalent political attitudes toward the existing institutional structure will soon undergo very substantial change as the financial plight of the system comes to be more widely recognized. For such an argument, see Carolyn Weaver, "The Long-Term Outlook for Social Security—Continued Political Turmoil," mimeographed (National Commission on Social Security Reform, October 1982).

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debt—a debt that exceeds by several times the nonindexed public debt that is nominally measured. The implicit debt of the existing (early 1980s) Social Security system is estimated to be roughly $8 trillion, by comparison with a nominally measured debt of something over $1 trillion.

It would be redundant to extend the discussion of these features of the system. The skeletal summary is useful, however, in any discussion of structural reform—discussion that becomes meaningful only when it involves comparing *relevant* alternatives. Critics and reformers of the existing structure have often faltered at precisely this point. In particular, the proposal for reform that would allow individuals to voluntarily opt out of the system has been treated as a relevant alternative when it is not. Such treatment reflects a crude fallacy of composition.

It is, of course, easy to show that many potential and actual participants in the existing system could substantially improve their positions if they were allowed to withdraw and invest voluntarily in their own preferred, privately marketed insurance plans. If a young employee, say at age 25, were allowed to withdraw voluntarily from the system, to relieve himself of all payroll-tax obligations (levied both against his wage directly and against his employer) and at the same time were to renounce all claims to future benefits from the system, he would be able to secure a rate of return under privately purchased insurance that would yield either the same level of expected benefits at substantially lower costs or substantially higher benefits at the same costs. Acknowledging this apparent comparative advantage of privately purchased insurance leads naturally to the inference that such a person, on grounds of economic self-interest, would cease to support the existing structure politically—hence, there should be a potential for organizing a political constituency to support the opting-out alternative.[4]

My central argument in this paper is that no such inference can be drawn. The disparity between individualized rates of return on "investment" within the system and outside it does not in itself

[4]In some extreme models, the paradox of support analyzed here does not arise, because there is no basic difference between debt and tax finance. The young person, by opting out, may secure a higher rate of return on private investment, but because future tax liabilities are reduced, he will expect lower bequests than would be expected in the system. Hence, the apparent advantages of opting out are not clear, except insofar as changes in the distribution of net burden can be accomplished. See Robert J. Barro, "Are Government Bonds Net Wealth?" *Journal of Political Economy* 82 (November 1974): 1095–1117.

My explanation of system survival does not in any way invoke a Barro-like model of intergenerational interdependence.

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provide a basis for political opposition to the existing structure. It does not do so because individualized opting out, or voluntary withdrawal, is not a relevant alternative and participants in the system do not treat it as such.

IV. Debt, Demos, and Default

People recognize that any structural reform that introduces the alternative of opting out would necessarily lead to the abandonment and breakdown of the intergenerational transfer scheme that exists. Therefore, when they face the question of supporting or opposing the proposal to opt out, individuals must model or estimate the alternative system that would replace the present one. The relevant alternative is the institutional structure that would emerge in lieu of the existing intergenerational transfer scheme. The relevant alternative is *not* the existing transfer scheme only with the individual having been removed from all tax obligations and all claims.

What alternative institution would emerge? To answer this question, the individual must try to predict how the democratic process will operate. If one predicts that the existing structure will be abandoned without any governmental-political-institutional replacement, then the attractiveness of the opting-out alternative to young and prospective employees might remain. But it is at this point that the summary description of the existing system in terms of the implicit national debt becomes helpful. Will individuals seriously consider default on the Social Security debt obligation to be an alternative?[5] Will government dishonor all of the claims to benefits from the system? Or will some means be found to finance at least some considerable share of the claims that individuals hold against the structure?

In making predictions here, each person must, willy-nilly, become his own public-choice economist. Moreover, in the calculus of politics, each individual must consider the following factors. First, the individual must recognize that his own normative position on the legitimacy or illegitimacy of claims against the existing system is not directly relevant, although some generalized prediction about normative attitudes over the whole citizenry must be made. That is, an

[5]The Social Security debt is singular in that the claims (the "bonds") are universally held by all past and present employees. Default on such widely held and uniformly distributed debt becomes much more difficult politically than default on nominal debt instruments. The latter, even if held internally, would tend to exhibit concentrated ownership, and, if held externally, would not have direct internal political representation. The potential effects of ownership patterns on prospects for debt default have not, to my knowledge, been carefully analyzed.

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individual may personally dismiss all claims on Social Security as being morally irrelevant. However, unless this personal attitude is generalized to others, some estimate must be made about how citizens in general feel about the moral status of existing claims.

Moral legitimacy aside, the individual must also recognize that members of several constituencies in the political community will support payment of Social Security claims, in full or in large part, on the basis of straightforward self-interest calculations. Those who would not find it advantageous to opt out of the existing system voluntarily, even if they could do so in isolation, will have self-interested reasons to support some other scheme of meeting the obligations of the system in the event that the system collapses. These individuals will never support default on the implicit national debt that the claims represent. These groups will of course include all those who are currently receiving benefits, as well as those who expect to collect benefits in the near future. Roughly speaking, the self-interested supporters of some replacement scheme that will meet the outstanding debt obligations will tend to include all participants over some critical middle-age limits (about age 40).[6]

Quite apart from both the moral legitimacy of existing claims and the self-interested motivations of individuals for receiving transfers, there is also the direct welfare obligation that would emerge in the absence of the existing system. Even if few people adhere to the notion that claims against the system are morally legitimate in some quasi-legal sense of entitlements, some individuals will recognize that the aged poor and disabled, now within and supported by the system, must be kept alive. And while a strictly administered, means-tested welfare structure may require substantially less revenue than the generalized benefit system now in existence does, little support could be predicted for total disregard for those who would be unable to find minimal subsistence without the Social Security umbrella as it is currently administered.[7]

Finally, the participant must include some estimate for increased support payments that might be necessary for the members of his own family who may be current recipients of Social Security benefits, but whose funds might be reduced under an alternative arrangement.

[6]Browning has analyzed the age-profile breakdown in support of continued increases in levels of benefit payments. Much the same sort of analysis could be used here to predict what groups would support meeting the system's debt claims, even in the event that the system collapses. See Edgar K. Browning, "Why the Social Insurance Budget is Too Large in a Democracy," *Economic Inquiry* 13 (September 1975): 373–88.

[7]The revenue requirement of the welfare obligation is mentioned as an offset in a somewhat different context by Gordon Tullock, in *The Economics of Income Redistribution* (Boston: Kluwer-Nijhoff, 1982), p. 114.

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Moral attitudes concerning the legitimacy of claims, self-interest, welfare, and own-family obligations (along with other considerations relating to citizens' potentially supporting or opposing any financing of a welfare scheme as a replacement for the one that exists) must be somehow estimated and then interjected into a model of how the politics of American representative democracy actually work. What constituency's pressures would be likely to be more influential? Elementary public-choice theory suggests that the more concentrated interests of potential beneficiaries are likely to carry somewhat more weight than the diffused interests of taxpayers, particularly if the beneficiaries' interest is accompanied by moral argument, whether on the grounds of default on debt or on the grounds of commitment to welfare.

It is difficult to imagine any rational calculus that would predict the total absence of political response to a breakdown and collapse of the existing social insurance system. It can be predicted that under almost any set of circumstances, major financing requirements will continue to exist regardless of the fate of the existing structure. The government is not likely to default on the implicit real debt that the mistakes of past generations have created.[8] The effective and relevant alternative to the existing system is a tax-transfer scheme that may not be substantially different, in essence, from the one that exists.

V. From the Aggregate to the Individual

In order for an individual to calculate whether he will be better off by switching to a replacement system, he must translate the public-choice predictions about the alternative tax-transfer scheme into individually identifiable tax obligations. The participant must estimate the present value of his future tax obligations under the existing structure, along with the present value of the benefits he can expect to receive under the alternative structure. The in-system estimates will not, of course, be easy to make, since here too some political modeling will be required. How will tax rates and benefit levels be adjusted as the political system responds to recurring short-term crises? Will the base for payroll taxation continue to be increased? Will elements of progressive taxation be increased or decreased?

[8]Because the implicit debt of the system is indexed, default via inflation is not possible, as is the case with nominal public debt. Furthermore, the measure of nominal debt may include a significant component for expected default, whereas no such component is included in real debt. Hence, the real debt overhang of the social insurance system may be considerably more than eight times as burdensome as the nominally measured debt, as is indicated by the ratio of $8 trillion to $1 trillion.

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Will the retirement age be changed? Will benefits be subjected to income taxes? Will benefits be overindexed, underindexed, or ideally adjusted? These questions will tend to be answered differently by different people, and even if there should be some similarity of political predictions, the age, income, and family status of an individual will make his estimates unique.

Assume now that a particular participant does go through the required estimation procedures and that the present values for taxes and benefits are predicted. These estimated present values then will provide the benchmark for comparing the existing system to the relevant alternative, the tax-transfer scheme that some predict will emerge.

My overall purpose is to explain why individuals who could be expected to find structural change advantageous nevertheless continue to support the existing system. Hence, I shall focus on the calculus of the young participant who under the structural change would renounce all claims to future benefits and who at the same time would be relieved of all payroll-tax obligations, present and future (whether levied on employee or on the employer). Such a person would normally expect to be required to pay taxes to finance some share in the replacement tax-transfer scheme that emerges. The critical relationship is that between the present value of this young participant's anticipated tax share and the present value of payroll taxes and benefits anticipated under the existing system.[9]

To the extent that payroll-tax obligations are reduced and are *not* offset by increased taxes under the replacement scheme, the individual in question will have additional funds to invest in private insurance. Critics and would-be reformers of the existing system have often overlooked the tax cost of any replacement scheme—a cost that the participant must always consider in any realistic comparison.

The calculation of an individual's tax obligation under the replacement institution will depend, of course, on the expected total cost of the new system. This cost is normally thought to be somewhat less than the projected cost of the existing system. Beyond such aggregate estimates, however, the individual must determine his own share of the cost. This estimate will depend first on a prediction of the tax or tax array that will be used to finance the replacement scheme (value-added tax, increased income-tax rates, broad-based consumption tax, and so on). Second, the estimate will depend on the individual's theory of incidence for the particular tax set predicted. Finally, the

[9]For simplicity, I shall assume that the individual making the calculations does not expect to receive any welfare benefits under the alternative system.

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estimate will depend on some predictions about the individual's own position in the possibly relevant age, income, family status, consumption pattern, and other profiles that determine tax liabilities.

VI. The Individual's Simple Algebra of Institutional Comparison

No claim is made here that the individual estimates of the present values for tax obligations and benefit claims will be simple. Any such estimates necessarily involve possibilities for major miscalculations. Nonetheless, it is essential to reduce the analysis of individual institutional choice to such specific detail if we are to understand the apparent near-universal support for the existing structure. This section, which is in many respects the core of the paper, develops the simple algebra of the comparison that the individual participant must make.

Initially, I shall define some terms, all of which are assumed to be dated as of the time that the individual participant confronts the institutional choice.

T_S^i — Individual *i*'s estimate of the present value of the tax obligations faced under the existing institutional arrangements, as these arrangements may be non-structurally modified in future periods.

T_A^i — Individual *i*'s estimate of the present value of the tax (and personal) obligations faced under the alternative tax-transfer arrangements that will be predicted to emerge as a structural replacement for the existing system if it is abandoned or repealed.

$\frac{T_A^i}{T_S^i} = t^i$ — The share (of his present-value tax obligations under the present system) that the individual anticipates will be drained away by taxes and personal outlays under the replacement system.

$(1 - t^i)$ — The share of each dollar's worth of present-value tax obligations under the existing system that individual *i* anticipates to be made available for private investment if the existing system is dropped.

r — The market-determined real rate of return on private investment.

Note that $(1 - t^i)$ also defines the present value of a dollar's worth of present-value tax obligations that is withdrawn for private invest-

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ment. Since $(1-t^i)$ is available for investment at a rate of r per period, this stream of returns (discounted at r) is simply $(1-t^i)$.

B_S^i Individual i's estimate of the present value of the benefit payments expected to be received under the existing system, as these arrangements may be nonstructurally modified over future periods.

$\frac{B_S^i}{T_S^i} = c^i$ The share of each dollar's worth of present-value tax obligation that individual i estimates to be offset by present-valued benefits.

For individual i to be indifferent toward the two institutional alternatives, the following condition must hold:

$$(1-t^i) = c^i \tag{1}$$

Several familiar relationships may be derived from (1). First, if $B_S^i = T_S^i$, or $c^i = 1$, *any* positive tax or personal outlay expected under a replacement institution is sufficient to cause the individual to prefer the existing structure. Second, if $B_S^i < T_S^i$, then $c^i < 1$. In this case, the individual may prefer the existing system if $t^i > 0$. The critical relationship is the one between t^i and c^i. If $t^i > c^i$, the individual will prefer the existing system; if $t^i < c^i$, the individual will support abandoning the existing system in favor of the alternative.

It may be helpful to redefine c^i in (1) as the ratio between the annualized stream of returns in perpetuity g, equal to the expected benefits of the system, and the market-determined rate of return (or the rate of discount) r. This yields:

$$(1-t^i) = g/r \tag{2}$$

The situation that is of particular interest is the one present when $t^i > c^i$ in (1), or when $g^i < r$ in (2), and when $t^i > 0$. Suppose $t^i = .6$, or $(1-t^i) = .4$; the individual anticipates that his dollar's tax obligation under the existing system, computed in present-value terms, will be reduced to \$.60 by a shift to the alternative tax-transfer scheme. From (1) it is clear that c^i only needs to be greater than \$.40 in order to ensure that the individual in question will support continuation of the existing structure. That is to say, the present value of the expected benefits can be as low as four-tenths the present value of expected tax payments without causing loss of support for continuation of the present system. In terms of (2), the annualized return of expected benefits (g) need only be four-tenths the rate of discount (r) in this setting. If, for example, given the value for $(1-t^i)$ of .4, with

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a rate of discount $r = .06$, any value for g above .024 will ensure support for the existing structure.[10]

The simple algebra of institutional comparison suggests that support for the existing system may persist even if individuals recognize that their "investments" of tax payments in the system are much less advantageous than their opportunities for investment in the market.[11] The algebra incorporates the recognition on the part of the individual that he is locked into a socioeconomic-political structure in which the exit option is effectively closed. The overhang of the implicit public debt that decisions of decades have created cannot be neglected. The simple algebra is helpful, however, in suggesting that support for the existing structure has limits. If, for any reason, the ratios defined in (1) and (2) reach critical levels for many people, popular support for the existing structure may rapidly erode. The near-universality of support now observed suggests only that the ratios have not yet attained such "subversive" levels.

VII. Parameter Shifts

The parameters that enter into the individual's comparison may be (1) exogenous to the system and exogenous to the individual's own calculus, (2) exogenous to the individual participant but endogenous to the system, or (3) endogenous to the participant.

Consider, first, the market rate of return (or rate of discount). How will an increase in this rate affect the representative individual's institutional comparison? Assume, first, that r (the real rate of return on capital) increases exogenously because of a technological change.

The time profile of taxes expected under the two institutions will differ in that the future taxes will tend to be "bunched" under the replacement tax-transfer scheme during the period in which the out-

[10]Note that g is *not* the internal rate of return to "investment" in the existing system. So long as a participant anticipates any positive return of benefits, then $g^i > 0$. And, of course, expected benefits may well be positive even if internal rates of return on system "investment" are negative. With any given value for g^i, there may be many internal rates of return, depending on the time profile of expected benefits.

[11]I have assumed throughout the analysis that the individual can secure the real rate of return, r, in the market. During periods of expected inflation, this assumption may not be warranted—especially if there exist legal restrictions on the private issue of indexed bonds. If any private investment must embody an inflation-risk premium, the individual may have an additional reason, over and above those discussed, for supporting the fully indexed pension scheme, regardless of its annualized rate of yield in relation to the riskless real rate of return.

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standing claims against the system are met. The numerator of the ratio T_A^i / T_S^i will tend to fall by less than the denominator as r increases. On the other side, the expected value of any fixed stream of benefits, B_S^i, will carry a lowered present value as r increases, and this value will fall by more than that of T_S^i. Hence, t^i will increase and c^i will decrease as r increases. The effects work in offsetting directions, although it seems plausible to suggest that c^i will fall more than t^i rises, hence making support for the existing system fall. This effect may be countered, however, if expected benefits increase as the real return on investment increases.

To the extent that the whole system, through time, acts to reduce the rate of capital formation, r will tend to increase endogenously to the system, and will ultimately reflect a reduction rather than an increase in the income base upon which taxes must be levied. In this case, expected benefits may fall. This effect, plus the differential capitalization effects of the separate time streams, would allow us to predict that support for the structure will fall.

The remaining parameters are all endogenous to the system, even though they may be exogenous to the participant. Consider a shift upward in the retirement age (say from 65 to 68) that is not offset by any other change in the system. If this change is made effective only after some time lag, the effect is unambiguously to reduce the value of c^i, without any noticeable effect on t^i. Hence, the existing institutional structure necessarily becomes less attractive to young participants.

Consider now a straightforward increase in the rate of tax on payrolls, with no change in the upper limit for the tax. The denominator in both of the relevant ratios, T_S^i, will increase, reducing the values for both t^i and c^i. The alternative replacement scheme would necessarily become relatively more attractive for all people who face tax obligations under the existing system. An increase in the upper limit for levying the payroll tax without increasing the basic rate will exert a similar effect, but only on those who will thereby face higher expected tax obligations.

Treating Social Security benefits as part of taxable income, wholly or partly, with revenues returned to the system, will make the system less attractive to those who expect to have above-average incomes. If the alternative tax base for the replacement tax-transfer scheme is a broad-based consumption tax or value-added tax instead of an income tax, the group that is directly affected would become more interested in abandoning the present Social Security system.

Internal changes in the benefit/payout ratios made to increase the internal progressivity of the overall system will have effects similar

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to those caused by making benefits taxable. The support of upper-income participants for the system may be eroded as internal progressivity is increased.[12]

Shifts in the parameters endogenous to the individual's own estimation process are more difficult to discuss analytically. The estimates for expected benefits and expected taxes within the system, and for expected taxes under the replacement system, are necessarily subjective. These estimates depend on the individual's modeling of politics as well as on his judgment about underlying demographic trends.

VIII. Strategy for Support

Having established the individual's algebra of institutional comparisons, we can now trace the familiar strategies of support for continuation of the existing structure. Those who are differentially advantaged by such continuation—the administering bureaucracy along with those who are net beneficiaries, present and future—will seek to influence (in specific directions) the estimates that present and prospective participants make. Clearly, it will be useful to try to get individuals to place a high value on both t^i and c^i, since a high value for both ratios lends support to the existing system.

A strategy that will act on both parameters is one that stresses the contractual basis for the claims of the existing structure. If it is convincing, this strategy will assure all prospective beneficiaries that the present values of expected benefits are indeed positive and high. At the same time, however, this strategy suggests that because the claims are contractual obligations, there will be a large carryover tax burden under any replacement scheme that might be politically viable.

It is also important to influence the values that are subjectively estimated for taxes expected under the system. From the earliest years of the system, the false argument that employees do not really bear the incidence of the employers' portion of the payroll tax has been used to make participants think they get more than any proper economic calculation would suggest. It is clearly in the interests of all supporters of the existing system to foster this fallacy.

Supporters of the system will tend to oppose increases in the retirement age (because such increases unambiguously make the system less attractive to all nonretirees) and also to oppose straightforward increases in the payroll tax. Faced with short-run emergency

[12]See Tullock, pp. 130–35, for a somewhat different direction in discussion of the effects of shifts in parameters on support for the system.

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adjustments, supporters will tend to favor increasing the upper limit for applying the tax, as well as including the benefits in the income tax, provided the system secures the return of revenues. Supporters will not desire to push the internal progressivity of the system so far that it loses the support of large numbers of high-income payroll-tax payers.

IX. Strategy for Opposition

For those who seek to undermine the existing structure and who recognize that the simple algebra of participants must be influenced to do so, the primary argument must be one that opposes the contractual basis for claims against the system. To the extent that people can be led to think that they personally have no legitimate claim against the system on retirement, the expected value of benefits is necessarily reduced. At the same time, the erosion of the notion of legitimacy of claims reduces the tax overhang that would be anticipated under some replacement tax-transfer scheme. Both effects tend to make abandonment of the system look more attractive.

When short-run "reforms" are needed, those who seek to undermine the support of the system (over the longer term) would do well to propose increases in the retirement age and increases in payroll taxes. These groups also should support proposals aimed at increasing the internal progressivity of the system. To the extent that participants come to perceive the system as a complex transfer scheme between current income classes instead of strictly between generations, the "insurance contract" image will become tarnished.

X. System Survival and Pareto Efficiency

The observed behavior of politicians suggests that there is no serious threat to the survival of the existing institutional structure of Social Security in the United States (in 1983), despite the sometimes anguished howls of the system's critics. The analysis in this paper explains the apparent paradox. To say that the system survives, however, is not the same thing as to say that it is Pareto efficient. An inefficient institution may survive until and unless ways can be found to secure political support for reform.

As the analysis has shown, the existing system may enjoy the support of participants who may expect significantly lower returns inside the system (compared to what they might earn outside the system) because such participants fear the tax burdens that are associated with the overhang of national debt that the system embodies. In order to generate political support for a replacement system from

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those who expect relatively lower in-system returns on "investment," it would be necessary to reduce (perhaps dramatically) the anticipated tax costs of the alternative tax-transfer scheme that is predicted to emerge.

At this point, it is useful to recall that there would be a specific time profile of the outlays required to pay off many or all of the existing claims that have accumulated within the existing structure. If the Social Security system should collapse in 1984, with no further collection of payroll taxes and no further accumulation of benefit claims, a commitment to meet its existing claims would require massive outlays over a two-to-three decade period, with substantial reductions beyond that time. It is this massive and time-bunched revenue requirement that creates the high values for t^i among many participants.

In order to reduce t^i, it would be necessary to assure participants that the burden of bailing out would not be allowed to fall disproportionately on the particular generation that would pay taxes immediately after the institutional reform takes place. To this purpose, I suggested elsewhere[13] that accumulated claims be met by issuing new debt intended specifically to insure that *all* future generations, along with the present one, share equally in the costs imposed by the mistakes of almost half a century. I shall not discuss my own proposal here. Suffice it to say only that unless proponents promise some stretching out of the revenue requirements for bailing out, the calculus of participants will presumably remain such that despite its apparent inefficiencies, the existing structure will continue to survive.

As I have already suggested, however, and as the simple algebra indicates, there are limits beyond which the existing Social Security system is unlikely to survive, even in the presence of the continually growing debt overhang. If the patchwork pattern of "reforms" is such that major support constituencies are lost, the system that has seemed politically sacrosanct may quickly become subject to intense intergroup distributive struggle. In that case, winners will win and losers will lose, with no guarantee that a replacement system will be any more efficient or equitable than the one that disappears.[14]

[13]See Buchanan, "Comment on Browning's Paper."

[14]As noted earlier, some observers predict that we are already in the beginning stages of such political turmoil. See Weaver, "The Long-Term Outlook for Social Security."

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"SOCIAL SECURITY SURVIVAL": A COMMENT

Mancur Olson

Introduction

Once again, Jim Buchanan, the founder and dean of the important Virginia School of Economics, has given us a most interesting and useful paper. It seems to me that he is right in saying that we need to analyze the Social Security system from a public-choice perspective, which I sometimes like to call a political-economy perspective. I also completely agree that we should not conclude from the fact that the Social Security system is politically very popular that it is therefore anything approaching a perfect system.

Now, I would not, however, go as far as Professor Buchanan does in describing our present Social Security system as a type of Ponzi scheme—a chain-letter scheme wherein each round makes contributions that profit those in earlier rounds but nothing is produced, so the scheme is fundamentally fraudulent and those in some later round or generation end up losing. It is true, of course, that our Social Security system is not funded. The government, as we all know, does not take the money from Social Security taxes, invest it, and then ultimately meet the claims of these taxpayers (when they retire) with this money and the interest it has earned. In essence, the present scheme is one whereby the working generation subsidizes the retired generation, and the expectation that sustains the system is that this process will continue through many successive generations.

There are certainly some important disadvantages, as Buchanan has pointed out, in an unfunded scheme of the kind that we have. It seems quite clear that the special circumstances that existed in the 1930s, when the Social Security system took shape, explain why we have an unfunded scheme. And even though it would have been

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The author is distinguished professor of economics, University of Maryland, College Park, Md. 20742.

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very nice if the scheme had gotten started in a different way, it is, I think, going too far to suggest that an unfunded scheme is totally and fundamentally wrong—so wrong as to be almost analogous to a Ponzi scheme.

A Folk Tale

My reasoning can perhaps best be illustrated by an old French folk tale about a peasant family in which a husband and his wife and children were taking care of the aged father of the husband in the family. The aged father was infirm and something of a burden, and the peasant's wife complained about having to have her father-in-law in the house. So much did she nag her husband about keeping his aged father there that finally one day the husband weakly said, "Yes, my father must go." So he told his son, "Go to the barn and get the best horse blanket we have for your grandfather." So the son went to get the blanket. But he came back with only half of the horse blanket, having torn it in two. At this point, the man of the house shouted at the son, "Do you expect to send your grandfather out on this cold day with only half the horse blanket?" At which point the son responded, "But father, I am saving the other half for you!" The father thereupon resolved that his father should indeed be allowed to remain in the house.

I suggest that this folk tale, which has its parallels in many other societies, reflects a fundamental characteristic of most traditional societies. Namely, it points to the traditional duty that adult working people have to support not only their children, but also their parents and other living ancestors. It also calls our attention to the likelihood that this folk tale and the similar folk wisdom in other cultures came to exist because of the true needs and conditions of traditional society.

Traditional Society and Provision for Old Age

In traditional society, by and large, it was often not possible for individuals to make provision for their old age through the capital market. Transportation and communication were so poor and transactions costs were so high that it was usually impossible for typical individuals to have diversified portfolios. At best, they could only invest in their own localities. But beyond that, traditional society was often politically unstable. So even if people invested in land in their home community, they could not be certain they would retain title over the long run, as military and political conditions changed. How then could people in traditional society provide for their old age?

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They could do it by having a large family, bringing up the children to respect their elders and to feel an obligation to provide for them when they become too old to work. Indeed, that is one of the reasons why large families were traditionally desired. When traditional and preindustrial societies began to modernize, however, the ethic that you should have lots of children, who would be brought up to take care of you in your old age, became less suitable. The change in attitudes, of course, did not happen overnight; it occurred slowly, as children became less useful as workers and as other ways of providing for retirement became available. We know from the theory of demographic transition that in every society that has become industrialized there has been a period of a generation or two when the birth rate has remained at traditionally high levels, even though the death rate has fallen and large families are no longer essential to provide for old age. There is a population explosion because it takes time to adjust the decisions about family size and retirement needs to the circumstances of modern society. At this very time in some underdeveloped countries, the problem of overpopulation is probably due in part to the fact that there has not yet been an adequate development of mechanisms for providing for retirement and old age, other than relying on children; nor has there been a complete adjustment to any new possibilities that may have emerged for providing for old age.

The Dilemma in Modern Society

Suppose we ask: Could we in modern society rely on the same mechanisms that traditional society relied on to provide for those who are too old to work? The extended family—or even the nuclear family, with all of its members in one place—is not something we can take for granted in modern society. The poignant modern dilemma of the husband and wife who have jobs in different cities reminds us of how it is quite impossible for all of the American people to be in a situation in which their families all reside in the same community. The extended family that could provide fairly well for retirement is inconsistent with modern methods of production, transportation, and communication. Consequently, modern families from industrialized nations are spread out and the extended family no longer exists. The grandparents are likely to be living thousands of miles from the grandchildren, which reduces the probability that the grandchildren will know them well and could in fact be persuaded to support them. So, as others have argued before, modern society needs some alternative to the traditional extended family to provide for old age.

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One possible mechanism for providing for old age is for individuals to utilize the private capital markets to accumulate wealth during their working years. But a glance at the average math-test performance of high school seniors reveals that a significant percentage of the population could not even perform the basic computations necessary to calculate an optimal level of retirement income. It may also be the case that the United States has been a modern industrialized society for too short a time to expect that *everyone* would have adapted in such a way that they would use the capital markets to provide for their retirement.

Thus it seems to me there is a case for a Social Security system that is not totally different from the one we have. Moreover, there is a case for treating the Social Security system, which subsidizes the older generations from the earnings of worker generations, as a more or less rational adaptation to the circumstances we are in. I therefore would argue for somewhat less sweeping changes in Social Security than Professor Buchanan.

Conclusion

Although I would not support abolition of the Social Security system, I would still support quite a large list of reforms. What I have said so far notwithstanding, I would on balance prefer a fully funded retirement system to a pay-as-you-go system of the sort we have, because a funded scheme would probably increase the rate of capital accumulation. However, it is probably best here to focus on one reform that calls to mind the spirit that I believe should guide our thinking in reforming Social Security. One of the least desirable features of the Social Security system is a feature that was put in during the 1930s, partly to make the system more like private insurance. This feature is the idea that the total amount paid in Social Security taxes and the size of the Social Security retirement income should rise, at least within a range, as the wage level rises; the proportion of working income that Social Security replaces should be roughly constant over a fairly broad range of incomes. This seems to me an ill-conceived idea.

We need, I believe, a Social Security system to make sure that everyone, however limited his earning abilities or his skills at actuarial arithmetic, will be able to survive old age without privation. But it seems to me we do not need and should not have a Social Security system that guarantees the improvident high-income person enough retirement income to maintain his relative position in the consumption hierarchy. If some high-income people who had lived

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affluently during their working years became less well off in old age, that would be no catastrophe. Indeed, experiences of that kind would teach people the value of being prudent and encourage them to plan for the future. On the other hand, letting people suffer real privation in old age seems to me not only needlessly harsh but in conflict with the time-honored ethic that children who can work ought to help support their parents in old age. This ethic is almost as natural and appropriate as the one that says that parents ought to provide sustenance for their children.

Both for the political reasons that Professor Buchanan put forth and for other reasons, I conclude that the way to improve Social Security is to begin where we are now and to make the improvements, if need be, one at a time. There is no place we can start except where we are now; and while this starting point is most imperfect, it is certainly not so utterly absurd that we must necessarily start all over again.

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THE ECONOMICS AND POLITICS OF THE EMERGENCE OF SOCIAL SECURITY: SOME IMPLICATIONS FOR REFORM

Carolyn L. Weaver

Introduction

Over the past 15 to 20 years, economists have offered a wide range of proposals for "radical" reform of Social Security, where "radical" is taken to imply either the explicit financing of the public debt implied by the system or else the partial or complete return to private supply. In one of the first of these proposals, offered by Buchanan and Campbell,[1] government bonds would have been issued to the trust funds in the full amount of the system's unfunded liability—its "covert" debt obligation. People would then have been permitted voluntary participation. Later, Buchanan developed a proposal to replace the payroll tax with a requirement for the compulsory purchase of Social Security bonds.[2] Individuals would then have been granted the option to purchase such bonds in the private sector, provided they carried a comparable return. More recently, Feldstein has argued for moving toward a fully funded system while maintain-

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The author is associate professor of economics, Virginia Polytechnic and State University, Blacksburg, Va. (on leave of absence), and a professional staff member, Senate Finance Committee, Washington, D.C. 20510.

This paper reflects the views of the author and does not necessarily reflect the views of any member of the Senate Finance Committee.

[1]James M. Buchanan and Colin D. Campbell, "Voluntary Social Security," *Wall Street Journal*, December 20, 1966, p. 14.

[2]James M. Buchanan, "Social Insurance in a Growing Economy: A Proposal for Radical Reform," *National Tax Journal* 21 (December 1968): 386–95.

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ing the government monopoly over the supply of Social Security.[3] Friedman, by contrast, endorses the complete privatization of the insurance functions of Social Security, a concept embraced by Ferrara and Wooten.[4]

The common theme of these reform proposals is that the compulsory, pay-as-you-go nature of Social Security in this country has resulted in significant efficiency losses for the citizenry—losses of both choice and wealth. Each of the proposals is an attempt to rationalize a seemingly irrational system; each is an attempt to put present and future generations in the position of benefiting from the fruits of their own savings and the economic growth that could be fostered.

At one level, it would seem, the political and economic climate has never been as fertile for proposals such as these. For the better part of a decade, the financing of Social Security has been in a shambles, and confidence in the long-term viability of the system is at an all-time low. If we know anything about the operation of pay-as-you-go systems and the probable course of mortality and longevity, the financing difficulties and confidence problems will only become more acute in the years ahead.[5]

At another level, particularly after the enactment of the 1983 Social Security Amendments—perceived by some to have been the loss of a great opportunity for "real reform"—it is easy to fall prey to a certain fatalism. The politics of a pay-as-you-go system, or the inability to terminate or significantly scale back such a program once under way, seems so ineluctable.

[3]Martin Feldstein, "The Social Security Fund and National Capital Accumulation," in *Funding Pensions: Issues and Implications for Financial Markets*, Conference Series no. 16 (Boston: Federal Reserve Bank of Boston, 1976). See also Michael J. Boskin, "Social Security: The Alternatives Before Us," in Michael J. Boskin, ed., *The Crisis in Social Security: Problems and Prospects* (San Francisco: Institute for Contemporary Studies, 1977), p. 175; and Daniel Orr, "Toward Necessary Reform of Social Security," *Policy Review* 2 (Fall 1977): 47–65.

[4]Wilbur J. Cohen and Milton Friedman, *Social Security: Universal or Selective?* (Washington, D.C.: American Enterprise Institute, 1972); Peter J. Ferrara, *Social Security: The Inherent Contradiction* (Washington, D.C.: Cato Institute, 1980); and James Wooten, testimony, Hearings before the Social Security Subcommittee, National Commission on Social Security Reform Recommendations, U.S. Senate, 98th Cong., 1st sess., February 24, 1983, pp. 330–53.

[5]This theme is developed in Carolyn L. Weaver, *Understanding the Sources and Dimensions of Crisis in Social Security: A First Step Toward Meaningful Reform* (Washington, D.C.: Fiscal Policy Council, 1981); idem, "The Long-term Outlook for Social Security—Continued Political Turmoil" (paper presented at a symposium sponsored by the McCahan Foundation for Research in Economic Security, Bryn Mawr, Pa., 1982); and idem, *The Crisis in Social Security: Economic and Political Origins* (Durham, N.C.: Duke University Press, 1982), pp. 175–93.

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In this paper I will argue that the conventional wisdom about pay-as-you-go systems—which is basic to understanding the growth and evolution of Social Security—is inadequate for explaining the emergence and, by inference, the reform of the system. The transitional "gains" to be made from enacting a social insurance program financed on a pay-as-you-go basis, like the transitional "losses" occasioned by reform, are no more significant to real policy outcomes than are the *expectations* that those gains or losses will materialize.

In the midst of the economic and political upheaval of the Great Depression, uncertainty of payoff in the distant future under the new pay-as-you-go social insurance system, compared to the status quo, underlay the failure of Social Security to emerge prior to 1935. The same factor—uncertainty of the alternative—will be a significant barrier to reform, now that the status quo is Social Security. However, real reductions in the expected payoff to perpetuating the system are already observable, as are the increased uncertainties of payoff. These forces will increase the comparative attractiveness of reform.

The paper begins by presenting the conventional wisdom on pay-as-you-go systems. The economic and political origins of Social Security are then carefully examined, as they provide insight into the potential for radical reform in the coming years.

The Conventional Wisdom on Pay-As-You-Go Systems

A public retirement system financed on a pay-as-you-go basis is one in which there is essentially no accumulation of reserves; instead, benefits to the retired generation are financed by a compulsory tax levied on the working population.[6] The benefits that can be paid under such a system, which determine the rate of return on taxes paid, vary in a predictable way over the life of the system. For analytical purposes, it is useful to distinguish two periods: the "start-up" period (during which time workers pay into the system over only part of their work lives) and the "mature" state (during which time the working population spends its entire work life under the system).

[6]See Edgar K. Browning, "Social Insurance and Intergenerational Transfers," *Journal of Law and Economics* 16 (October 1973): 215–73; Joseph A. Pechman, Henry J. Aaron, and Michael K. Taussig, *Social Security: Perspectives for Reform* (Washington, D.C.: Brookings Institution, 1968); and Paul A. Samuelson, "An Exact Consumption-Loan Model of Interest with or without the Social Contrivance of Money," *Journal of Political Economy* 65 (December 1958): 467–82. See Edgar K. Browning, "Why the Social Insurance Budget Is Too Large in a Democracy," *Economic Inquiry* 13 (September 1975): 373–88, for the seminal work on the politics of pay-as-you-go systems.

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Given any rate of taxation, and holding everything else constant, the rate of return on tax payments is extraordinarily high for generations near retirement at the time of the adoption of the system. Furthermore, during the transition to a mature state, the rate of return remains well above that payable in the long term. All of the revenues collected by the government—a simple function of the tax rate and taxable wages in the economy—can be paid out to people as they retire, although they may have contributed to the system for only a brief period.

The older the system and (thus) the longer people will have paid taxes before receiving benefits, the lower the rate of return on tax payments. Ultimately, under a mature system, the average real rate of return payable is limited to the growth rate of the wage base as determined by labor productivity and employment in the economy. At least theoretically, this long-term sustainable rate may or may not compare favorably with the rate of return on private investments as determined by the productivity of capital in the economy.[7]

Once in place, the incentive to expand such a system is significant. The higher the tax rate imposed in this period (or the larger the group that is compulsorily covered), the higher the benefits payable and thus the rates of return, for all of the currently retired, those nearing retirement, and those who will not be subject to the higher tax for their entire working life. Unlike under a funded system, a decision to increase the tax rate represents a collective decision to alter the distribution of rates of return between generations—transferring income from the future generations to the present—rather than simply a decision to "save" more at a given return. In effect, expansions in the program postpone the maturing of the system and perpetuate the gains made possible during the transition.

The incentive to eliminate such a system, by contrast, is nonexistent. Once again, unlike a funded system in which accumulated reserves would be sufficient to pay off any accrued liability, eliminating a pay-as-you-go system, or setting the tax rate equal to zero, is equivalent to paying no further benefits to anyone, now or in the future. Everyone alive who has paid any taxes at all would receive a rate of return equal to minus 100 percent and would rationally oppose any such effort. Any reduction in the tax rate would likewise reduce returns.

[7]According to estimates made by Martin Feldstein, the long-term rate of growth of the wage base is unlikely to exceed 1 to 2 percent, whereas additional investment in the corporate-sector capital stock would yield a real pretax return of about 12 percent. See Feldstein, "The Social Security Fund," pp. 43, 46–47.

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Taken literally, this simplistic presentation of the operation of a pay-as-you-go system implies the following.

- It always pays to create a pay-as-you-go system, although such a system may or may not make sense in the long term;
- It generally pays to expand a pay-as-you-go system; and
- It never pays to eliminate the system, regardless of how poor the return becomes.

So goes the conventional wisdom.

As a method of analyzing the evolution and growth of Social Security, this simple model has great explanatory power. As a method for analyzing the present "crisis" in Social Security, this model is equally useful. Much of the political tension today results from nothing so much as the inevitable deterioration in returns resulting from the maturing of the system, exacerbated by adverse economic and demographic changes. Coverage is nearly universal, the ceiling on taxable earnings now exceeds the earnings of the vast majority of the population (93 percent), and the only way to maintain or improve returns in the face of historically low real wage growth is to further increase taxes. But for nearly half the taxpaying population, Social Security taxes already take a bigger bite out of earnings than federal income taxes.[8] Given the significant redistributive elements of the system, rates of the return look especially low for young, higher-income people.[9]

As a model for explaining the emergence of Social Security in this country, however, something is evidently missing from the analysis. Under the original Social Security bill, retirement benefits were payable to people 65 and older who had contributed to the system

[8]On the basis of 1979 data, the Social Security Administration found that 24 percent of households paying Social Security taxes, or 18 percent of all households, paid more to Social Security than to the Internal Revenue Service—and this is only if the employee tax is considered. If it is assumed that the employee pays the employer's share too, in the form of lower wages, 51 percent of taxpaying households pay more in Social Security than income taxes. "Family Social Security Taxes Compared with Federal Income Taxes, 1979," *Social Security Bulletin* 44 (December 1981): 12–18. See also Joseph A. Pechman, "The Social Security System: An Overview," in Boskin, ed., *The Crisis in Social Security;* and Roger Leroy Miller, "Social Security: The Cruelest Tax," *Harpers,* June 1974, pp. 22–27.

[9]See, for instance, Michael D. Hurd and John B. Shoven, "The Distributional Impact of Social Security," National Bureau of Economic Research, Working Paper no. 1155, June 1983; and Orlo R. Nichols and Richard G. Schreitmueller, "Some Comparisons of the Value of a Worker's Social Security Taxes and Benefits," Actuarial Note no. 95, HEW Pub. no. (SSA) 78-11500, April 1978. Both of these studies were conducted prior to the 1983 legislation, which by taxing benefits, raising the retirement age, and increasing taxes, further reduced returns for young, high-income workers.

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for as few as four years. Administration estimates at the time projected that everyone retiring during this century could receive unearned benefits under the proposed distribution of taxes and benefits, with the aggregate amount of unearned benefits amounting to $500 million a year (in 1934 dollars).[10]

Yet Social Security, or more specifically, compulsory Old-Age Insurance (OAI), emerged from Congress in 1935 against a backdrop of significant and broad-based political opposition.[11] Already six years into the Great Depression and with nearly 20 million people on direct government relief, the program was challenged at every step of the legislative process. When the Social Security Act was finally passed, some 46 years after OAI had emerged in Europe, the United States became the last industrial country in the world to enact a national scheme to aid the elderly.

It is not as though Congress and the public were uninterested in the well-being of the elderly or unaware of social insurance as a mechanism for redistributing income. On the contrary, considerable attention was accorded the elderly and the problems of retirement-income security. Even before the Great Depression, 13 states established commissions to study the financial condition of the elderly and report on the advisability of public action.[12] Proposals to make cash transfers to the elderly poor were debated by most state legislatures.

In part, this interest was a response to the marked demographic changes taking place at the turn of the century. For some 40 years (between 1880 and 1920), the elderly population grew faster than

[10]See *Report of the U.S. Committee on Economic Security*, Hearings before the Committee on Finance on S.1130, U.S. Senate, 74th Cong., 1st sess., January 22–February 20, 1935, pp. 1334–36; and Edwin Witte, "Old-Age Security in the Social Security Act," in Robert Lampman, ed., *Social Security Perspectives: Essays by Edwin Witte* (Madison: University of Wisconsin Press, 1962).

[11]See Edwin Witte, *The Development of the Social Security Act* (Madison: University of Wisconsin Press, 1963); Arthur Altmeyer, *The Formative Years in Social Security* (Madison: University of Wisconsin Press, 1968); Paul Douglas, *Social Security in the United States* (New York: McGraw-Hill, 1939); and Carolyn L. Weaver, "On the Lack of a Political Market for Social Security Prior to the Great Depression: Insights from Economic Theories of Government," *Explorations in Economic History* 20 (1983): 294–308. See Weaver, *The Crisis in Social Security*, for a thorough development of the argument made here and the historical perspective provided.

[12]See New York Commission on Old-Age Security, *Old-Age Security*, Leg. Doc. no. 67 (Albany: J. B. Lyons, 1930), pp. 48–49, 312–24, 220–70. See also "Old-Age Pensions and Relief," *Bulletin of the U.S. Bureau of Labor Statistics*, no. 439 (1927), pp. 431–36; "Old-Age Pensions and Relief," *Bulletin of the U.S. Bureau of Labor Statistics*, no. 491 (1929), pp. 529–32; and Abraham Epstein, *Insecurity: A Challenge to America* (New York: Random House, 1938), pp. 532–50.

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the overall population, and during the 1920s alone, it grew at twice the rate of the overall population (reaching 5.4 percent of the total population in 1930). For the balance of the population, the median age rose from 22 to more than 26 in the period from 1890 to 1930, and the probability that a young worker would live to age 65 increased from 41 percent to 60 percent—the odds exceeding 50:50 for the first time at the turn of the century. The amount of time the young worker could expect to spend in retirement was thereby doubled.[13]

Equally important, there was an active core of advocates for the elderly in the early social insurance movement. Originating at the turn of the century with the founding of the American Association for Labor Legislation (AALL), the social insurance movement was led by social workers, social scientists, socialists, and other progressives who banded together in the name of "worker security." Workmen's compensation, national health insurance, unemployment compensation, and compulsory old-age insurance were all a part of their agenda. Designed to provide "low-cost insurance" to wage earners through a compulsory tax-transfer scheme, compulsory old-age insurance was a mechanism, said proponents, for substituting income security in the public sector for the uncertainty inherent in the private sector.[14]

The Failure of the Early Movement for Social Insurance

In this country the response to proposals for social insurance and other collective welfare schemes was poor.[15] Compulsory insurance was described by the Massachusetts Commission on Old-Age Pensions (in 1910), for example, as "unthinkable and distasteful."[16] For

[13]U.S. Bureau of the Census, *The Statistical History of the U.S. from Colonial Times to the Present* (New York: Basic Books, 1970); U.S. Department of Commerce, *Historical Statistics of the U.S. from Colonial Times to 1970* (Washington, D.C.: Government Printing Office, 1976); and Michael Darby, *The Effects of Social Security on Income and the Capital Stock*, Study no. 227 (Washington, D.C.: American Enterprise Institute, 1979), pp. 23–26.

[14]See, for instance, Barbara Armstrong, *Insuring the Essentials: Minimum Wage Plus Social Insurance—A Living Wage Program* (New York: Macmillan, 1932); Isaac Rubinow, *The Quest for Security* (New York: Henry Holt, 1934); and Epstein. For an informative recent piece on the early social insurance movement, see Roy Lubove, *The Struggle for Social Security: 1900–1935* (Cambridge, Mass.: Harvard University Press, 1968).

[15]See Weaver, *The Crisis in Social Security*, pp. 39–41, and idem, "On the Lack of a Political Market."

[16]Lubove, *The Struggle for Social Security*, pp. 118–19; New York Commission, *Old-Age Security*, pp. 48, 312–13; and Hace Tishler, *Self-Reliance and Social Security: 1870–1917* (Port Washington, Wis.: Kennikat Press, 1971), p. 88.

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the Pennsylvania Chamber of Commerce (in 1924), compulsory public schemes to aid the elderly were "un-American and socialistic and unmistakably earmarked as an entering wedge of communist propaganda."[17] And for Samuel Gompers (in 1917), president of the American Federation of Labor, social insurance was "in its essence undemocratic."[18] In 1916, he vowed to assist in the "inauguration of a revolution against compulsory insurance."[19] On the eve of the Great Depression, only one out of the 21 reports that had been commissioned by state legislatures endorsed compulsory insurance.[20]

Predictably, the onset of the Great Depression in 1929 and the election of Franklin Roosevelt in 1932 revived interest in social insurance and indeed in a wide variety of proposals for using the coercive powers of the federal government to redistribute income. Advocates fueled the notion that the depression was the failure of a "wage-based" economy or, in the president's words, the product of a "disintegrating system of production and exchange."[21]

The collapse of private banking and savings institutions and sustained high rates of unemployment, particularly acute among the elderly, threatened two vital means of financial support for persons of all ages. Between 1929 and 1933, one-fifth of all commercial banks failed, and unemployment rose to 25 percent of the labor force. Between September 1929 and June 1932, the real value of all stocks listed on the New York Stock Exchange fell nearly 80 percent, and by 1934 real personal savings had fallen by $33 billion. As late as November 1934, some 19 million persons, or 15 percent of the population, were receiving emergency or work relief from the various levels of government.[22]

Yet as the depression worsened, Congress was no more inclined to enact Social Security than in earlier years. The legislative response to poverty among the elderly was more direct—toward subsidization

[17]Cited in Lubove, p. 139.

[18]Samuel Gompers, "Not Even Compulsory Benevolence Will Do," *The American Federationist* 24 (1917): 48.

[19]Cited in Lubove, p. 168.

[20]New York Commission, *Old-Age Security*, pp. 312–24.

[21]Speech delivered March 5, 1934, to a meeting of the National Recovery Administration, cited in *Congressional Record*, June 22, 1935, p. 9906.

[22]Milton Friedman and Anna Schwartz, *A Monetary History of the United States: 1867–1960* (Princeton: Princeton University Press, 1963), pp. 299–419; U.S. Department of Commerce, *Survey of Current Business*, no. 8 (January 1933), p. 105; and *Survey of Current Business: Annual Supplement, 1932*, p. 33; U.S. Bureau of the Census, *Historical Statistics*, p. 266; *Supplement to the Report of the Committee on Economic Security*, Hearings before the Committee on Finance on S.1130, p. 40; and U.S. Social Security Board, *Trends in Public Assistance: 1933–39*, p. 6.

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of poverty assistance programs at the state and local level rather than the imposition of a tax on young people, many of whom were poor, in order to transfer income to the elderly, high and low income alike. The depression was putting great strains on the old-age assistance (means-tested welfare) programs sprouting up across the nation. Between 1930 and 1934 alone, the yearly cost of old-age assistance rose from $2 million to $32 million, nearly twentyfold in real terms, and the number of recipients increased from about 11,000 to 235,000.[23]

By 1934, federal assistance to the elderly poor had become a major campaign issue. Organized labor and the Democratic party were joined by business organizations and the Republican party in endorsing such legislation. In that year, a bill (the Dill-Connery bill) authorizing federal aid to the states gained unanimous support in both the House Labor Committee and the Senate Finance Committee.[24] Still, no bill calling for compulsory OAI had even been introduced into Congress.

Why So Much Resistance to Social Security? Further Thoughts on Pay-As-You-Go Financing

Understanding the widespread reluctance to enact Social Security requires taking the conventional view of pay-as-you-go systems a step further—to account for uncertainty. Opposition to the creation of the new system may well have been the rational response to the extreme uncertainty of payoff, ex ante, for most people.[25] Certainly those who were already elderly or near retirement in 1935 could plan, with a relatively high degree of confidence, on receiving net transfers from Social Security. Unearned benefits were typical of the start-up phase of retirement programs throughout the world, and indeed even in most private systems. And of course, with benefits likely to be payable after only minimal time under the system, the risks were low. Recognizing these factors, it should come as no surprise that when the elderly emerged as a political force in their own right in the 1930s, as epitomized by the "Townsend movement,"

[23]"Experience Under State Old-Age Pension Acts in 1935," *Monthly Labor Review* 34 (October 1936): 830–36; "Congress Faces the Question of Old-Age Pensions," *Congressional Digest* 14 (March 1935): 72; and *Supplement to the Report of the CES*, Hearings before the Committee on Finance on S.1130, pp. 50–51.

[24]See Epstein, pp. 533, 546; Douglas, pp. 10–11; Witte, *The Development of the Social Security Act*, pp. 5, 7; and American Association for Old-Age Security, "Both Major Parties Promise Social Legislation," *Bulletin of the AAOAS* 8 (June/July 1934): 5–6.

[25]This sections draws on Weaver, "On the Lack of a Political Market," and idem, *The Crisis in Social Security*, pp. 49–51.

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transfers much larger than those in the Social Security bill were sought.[26]

For younger workers, by contrast, an intergenerational transfer scheme was only potentially profitable and the stakes were very high. The potential profitability lay in the fact that since social insurance programs were not fully funded, retirees could earn an extranormal return on their taxes for many years as income was transferred intergenerationally. Social insurance offered another potential for profit that could prevail over time. The expected returns for similarly situated workers in any particular generation were politically determined—returns did not have to be equal, since they were not constrained by market forces. Thus, depending on one's income class, or family or marital status, the return earned by particular classes of retirees could be even higher than that earned on average.

All of these benefits, however, were *contingent* upon the initially agreed-upon institutional arrangement actually coming to pass at the time of retirement—a point generally neglected in current discussions of the "gains" to be made from pay-as-you-go systems or the "losses" resulting from reform. Under an unfunded social insurance scheme, a decision at some time in the future to lower taxes or reduce benefits would lower rates of return not only for current retirees but also for all the workers who had already paid into the system. The same problem would result from any decline in the growth of tax revenues, such as that caused by an adverse economic or demographic change, only the effect on returns would be permanent. A simple decision—to tilt the benefit formula toward high- or low-average earners, or to cap benefits, tax benefits, lengthen eligibility requirements, or apply offsets for other pension income—could generate huge windfall losses for certain retirees. In relation to the status quo, extranormal (or even positive) returns required the assurance of political control over time and thus the ability to raise taxes to buttress returns at the time of retirement. Evidently, without legally enforceable contracts, there was no certainty of payoff, in an ex ante sense.

The experience that workers had with underfunded schemes—including public retirement systems for state and municipal employ-

[26]The Townsend Plan would have provided payments to the elderly of $200 ($1,500 in 1982 dollars) monthly, provided they quit work and spent the entire check in the month received. The Townsend movement was said to have 3.5 million paid supporters by 1935. See Committee on Old-Age Security, *The Townsend Crusade* (Washington, D.C.: Twentieth Century Fund, 1936); "Is the Townsend Plan for 'Old-Age Revolving Pensions' Sound?" *Congressional Digest* 14 (March 1935): 92–94; and Douglas, pp. 69–74.

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ees, some company and trade-union pensions, and many of the life insurance companies that failed in the late 1800s—all clearly revealed a high degree of risk in this regard.[27] Overexpansion of benefits in the early years, when assessment rates were deceptively low, produced too high a structure of future tax rates as well as an unwillingness on the part of younger workers to continue benefit payments. Benefit reductions and outright default in such plans were commonplace. In trade-union plans, there were ongoing struggles between retirees and active workers over benefit levels as compared to assessment rates, with no clear pattern of resolution. While compulsory participation at the federal level could add permanence to an intergenerational transfer scheme by preventing voluntary exit by the young, this would be true only to the extent that younger workers lacked political control.

What did social insurance mean for organized labor? It meant a relatively certain tax on its membership (already sharply declining), in exchange for uncertain future benefits. It also meant the probable termination of their own pension plans, over which they had direct administration and control, in exchange for shared political control. As of 1928, some 1.6 million workers, or 41 percent of all trade unionists, belonged to unions providing old-age benefits.[28] At least during the pre-depression years, these benefit plans were perceived as both member-attracting and member-sustaining features.

Surely the Great Depression had a profound effect on the risk that people assigned to the status quo and the uncertainty associated with various social insurance alternatives. As sources of retirement income, labor earnings and private savings became considerably riskier for certain individuals—particularly those already in retirement or close to it. As a countervailing pressure, however, the shifts in political power bases occasioned by the Great Depression must have increased the uncertainty associated with the payoff under any particular social insurance proposal (with no more security than could be offered by an intergenerational "compact"). With the median age of the population just 26 (in 1930), a large proportion of the population could have made the quite rational judgment that the risk of losses under

[27]"Public Service Retirement Systems in the U.S.," *Bulletin of the U.S. Bureau of Labor Statistics*, no. 491 (1929), pp. 542-47; "Public Service Retirement Systems: U.S., Canada, and Europe," *Bulletin of the U.S. Bureau of Labor Statistics*, no. 477 (1929), pp. 1–170; Murray Latimer, *Trade Union Pension Systems* (New York: Industrial Relations Counselors, 1932); and Paul Studensky, *The Pension Problem and the Philosophy of Contributions* (New York: Pension Publishers, 1917).

[28]Latimer, pp. 113–16. See also William C. Greenough and Francis P. King, *Pension Plans and Public Policy* (New York: Columbia University Press), pp. 40–42.

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a pay-as-you-go system, when compared to the status quo, offset the potential for gains in the distant future.

The Shift in Political Power toward Social Insurance

Given this environment, there was an extraordinary shift in political power in 1934 that proved to be decisive for the enactment of Social Security. In that year, President Roosevelt intervened to take the political momentum behind old-age assistance to propel his own program of Social Security. As described by Paul Douglas, an active proponent of social insurance: "[T]he President wanted to delay Congressional action [on the Dill-Connery bill] in order that he might make the program his own. . . . The President's desire to combine old-age pensions with a general program of social security and his belief that a unified program should be worked out were, therefore, powerful factors in preventing Congress from passing the Dill-Connery bill."[29] The old-age-assistance bill died in the 72d session of Congress, having failed to gain the president's support.

Shortly thereafter, on June 8, 1934, Roosevelt addressed Congress on the general issue of Social Security. Calling for reconstruction measures to create adequate housing, jobs, and "some safeguards against the misfortunes which cannot be wholly eliminated in this man-made world of ours," the president announced his intention to formulate a comprehensive plan to "provide at once security against several of the disturbing factors in life—especially those which relate to unemployment and old-age."[30]

Three weeks later, by executive order, the president created the Committee on Economic Security (CES). Entrusted with the responsibility of fully exploring the question of Social Security during the remainder of the year, the CES was instructed to report to Congress with a definite program of action in January. At the top of the policy group were five cabinet members: Frances Perkins, secretary of labor; Harry Hopkins, federal emergency relief administrator; Henry Morgenthau, secretary of the treasury; Homer Cummings, attorney general; and Henry Wallace, secretary of agriculture—with Perkins named chairman. Subordinate to the committee was a technical board selected by the CES and composed exclusively of individuals from federal departments and agencies, an executive director selected by the CES, and an advisory council selected by the president. Arthur Altmeyer, assistant secretary of labor, was appointed head of the tech-

[29]Douglas, pp. 11, 26.

[30]Text of speech in *Congressional Record,* June 8, 1934, pp. 10769–71.

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nical board; Dr. Edwin Witte, member of the Economics Department of the University of Wisconsin, was selected as executive director. Under the chairmanship of Dr. Frank Graham (president of the University of North Carolina), the advisory council was established to represent "the public" at large. Social reformers and other advocates of social insurance were well represented at all levels in this administrative organ of the president.[31]

The final report of the CES, transmitted to Congress on January 17, 1935, was far-reaching. Proposals for a tax-offset system of unemployment compensation and federal grants to states for mothers' pensions, care for dependent and crippled children, and public health programs were included, along with proposals for federal grants to the states for old-age assistance, a voluntary annuities program, and old-age insurance—the latter being the only compulsory and entirely federal program.[32] Each of the proposals was consolidated into a comprehensive bill, "the economic security bill," which was introduced into Congress two days later.

Despite the enormity of the bill before Congress (members had 2,500 pages of expert testimony and 12 volumes of technical materials used by the CES to peruse), there was no point in the ensuing legislative process during which the proposal for OAI failed to generate sharp opposition.[33] No feature of the proposal went without criticism; no fallacy went unnoticed. As Altmeyer (who would hold Social Security's top appointed position from 1937 to 1953) recounted, leading members of the House Ways and Means Committee approached the president "to tell him it would not be possible to get a favorable vote on this feature of the bill."[34] According to Witte, "it seemed probable" that the "OAI titles would be completely stricken from the bill."[35] On the House floor, with the Democrats out-

[31]See Witte, *The Development of the Social Security Act*, pp. 201–2; Charles McKinley and Robert W. Frase, *Launching Social Security: A Capture-and-Record Account, 1935-1937* (Madison: University of Wisconsin Press, 1970), pp. 9–10; Douglas, pp. 27–28; Altmeyer, *The Formative Years*, pp. 7–29; and Frances Perkins, *The Roosevelt I Knew* (New York: Harper and Row, 1946), pp. 278–301. For a comprehensive legislative account, see Robert Stevens, ed., *The Statutory History of the United States: Income Security* (New York: Chelsea House, 1970), pp. 59–88.

[32]*Report of the Committee on Economic Security*, Hearings before the Committee on Finance on S.1130.

[33]For more on this, see Witte, *The Development of the Social Security Act;* Altmeyer; and Douglas.

[34]Altmeyer, pp. 12, 34.

[35]Witte, *The Development of the Social Security Act*, p. 90.

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numbering Republicans by three to one, an amendment to strike the OAI program mustered a third of the votes cast (65 to 128).[36]

On the Senate side, opposition to the administration's proposal was no less intense. On the floor of the Senate, where Democrats held a two-to-one margin, an amendment was adopted (by a vote of 51 to 35) which, if enacted into law, would have been the death knell for Social Security as envisioned by Roosevelt. Under the Clark amendment, employers were granted the option to contract out of the public system if they provided comparable retirement protection.[37] As one opponent said, this was the equivalent of the government "inviting and encouraging competition with its own plan which ultimately would undermine and destroy it."[38] In conference, it was an unresolved issue over OAI, and in particular the question of whether Social Security would be competitively supplied, that delayed the final passage of the entire Social Security Act. Despite all this, Social Security was law by summer, signed by the president on August 14, 1935.[39]

The Politics of the Legislative Agenda

Difficult indeed would be the task of finding a better example of the force of an all-or-none offer (short of the summer of 1981, when the powers of the reconciliation process were used so effectively to cut federal spending and taxes). Information was controlled by advocates, alternatives were restricted, and programs were bundled so as to preclude anything approaching a competitive political outcome. These, it is argued—not the potential "profitability" of the system—were the decisive factors in the enactment of Social Security in 1935.[40]

Information Control

In an atmosphere of crisis, social insurance advocates secured a measure of control over the outcome by simply dominating the information presented to Congress and the public on such issues as the "failure" of private savings and insurance institutions, the extent and

[36]Douglas, pp. 109–10.

[37]See *Congressional Record,* June 17, 1935, p. 9442; June 18, 1935, pp. 9510–36; and June 19, 1935, pp. 9625–33. See also Witte, *The Development of the Social Security Act,* pp. 88, 102–08, 157; and Douglas, pp. 120–25, 252–65.

[38]*Congressional Record,* June 18, 1935, pp. 9532–33.

[39]Witte, *The Development of the Social Security Act,* pp. 159–62; *Congressional Record,* August 9, 1935, pp. 12793–94; and Altmeyer, p. 42.

[40]This section draws on Weaver, *The Crisis in Social Security,* pp. 71–76.

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causes of poverty among the elderly, and "viable" institutional alternatives. In part, this was an outgrowth of having a stronger incentive than opponents to invest in acquiring and disseminating information on alternative social policies. The rewards to the advocate who exhibited active support for Social Security and helped see it through to enactment went beyond the shared benefit of having improved the world for all advocates. A job in the newly created bureaucracy, a staff position in Congress, an expanded realm for an existing agency, and jobs for students and colleagues, as well as expanded research and consulting possibilities, were but a few of the spillovers that could accrue to the advocate. Then too, advocates were frequently engaged in the types of employment (such as government agencies, social work, or universities) that facilitated (or funded) research in support of government programs.[41]

Opponents had a difficult time competing. Since proposals for compulsory old-age insurance were not seriously entertained before the economic security bill, there was little incentive to invest in acquiring and disseminating counter information and drafting alternative proposals. Likewise, there were no well established congressional committees or subcommittees to oversee such studies. On the basis of time alone, once the CES had been appointed and its staff of experts organized, opponents simply could not compete—in the span of just five months—in turning out the volume and quality of documentary support for their proposals. At the same time, individuals had little ability to capture the benefits of costly research and lobbying. For example, since effectively blocking OAI would secure benefits for all insurance companies, or all young people, whether or not they had participated in sharing the cost, each opponent was motivated to free-ride on the activities of the other opponents.

In essence, even if the CES had not been created to supersede Congress and had not presented Congress with a complex tied package of institutions, competing sources of information were likely to have been outweighed by the information made available by proponents of social insurance. They were the ones with the time, the

[41]On uncertainty and information manipulation, see Gordon Tullock, *Toward a Mathematics of Politics* (Ann Arbor: University of Michigan Press, 1967), pp. 100–32; and Randall Bartlett, *Economic Foundations of Political Power* (New York: The Free Press, 1973), pp. 70–75. On the economics of lobbying, see Peter H. Aranson and Peter C. Ordeshook, "A Prolegomenon to the Theory of the Failure of Representative Democracy," in R. D. Auster and B. Sears, eds., *American Re-evolution* (Tucson: University of Arizona, 1977); and for a similar model, see Tullock, "The Paradox of Revolution,"*Public Choice* 11 (Fall 1971): 89–99; and Richard Auster, "The GPITPC and Institutional Entropy," *Public Choice* 19 (Fall 1974): 77–83.

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funds, the expertise, as well as the ability to capture the rewards of their activities.

Agenda Control, Tie-In Sales, and All-or-Nothing Offers

President Roosevelt then bypassed Congress to establish a committee that would draft its own legislation. Staffed by an array of carefully selected cabinet members and advocate "experts," the CES had a vested interest in expanding the role of the federal government and in advancing programs with specific institutional features. The CES responded to the emerging demands for old-age security not with proposals for changes in legal, tax, or direct financial incentives for pensioning firms, for example, but by advancing a compulsory federal old-age insurance program, along with an entire array of federal/state welfare programs.

Of what significance was all of this? If the CES had simply been one of many freely competing suppliers of proposals, there would have been little significance to who drafted the bill and the particulars of the bill. But, by creating, staffing, and funding the CES with the purpose of formulating a Social Security program outside of Congress, elements of monopoly were created in the agenda formation process. The CES was federally subsidized to produce a bill and to produce a bill of a certain type—one that satisfied Roosevelt's expressed demands for a comprehensive, unified, and permanent program of Social Security, and one that was consistent with the objectives of its members.

These subsidies produced a type of power that could not be eroded by the existence of competing suppliers. Once the CES report was on the agenda, reasonable counterproposals were extremely costly to submit. In many cases, these costs would have been borne directly by participants rather than diffused through taxpayer support. And as suggested earlier, the creation of a competing proposal would have been analogous to the production of a public good for opponents. The power of the CES via subsidized information was thereby compounded by the pervasive problem of an undersupply of proposals.

More important to the nature and timing of the legislation, however, was the administration's use of standard monopoly practices, including the tie-in sale and all-or-nothing offer.[42] The tie-in sale, in

[42]For models of agenda control in the public sector, see Charles Plott and Michael Levine, "A Model of Agenda Influence on Committee Decisions," *American Economic Review* 68 (March 1978): 146–60; Robert J. Mackay and Carolyn L. Weaver, "Commodity Bundling and Agenda Control in the Public Sector," *Quarterly Journal of Economics* (forthcoming 1983); idem, "Agenda Control by Budget Maximizers in a Multi-Bureau Setting," *Public Choice* 36 (Winter 1981): 325–52; and Thomas Romer and Howard Rosenthal, "Political Resource Allocation, Controlled Agendas and the Status Quo," *Public Choice* 33 (Winter 1978): 27–43.

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this context, was the exchange of the legislator's vote for a bundle of programs. The right to "purchase" one activity over which the government maintained a monopoly (such as emergency relief funds) was tied to the purchase of some other activity (namely, OAI). Rather than being able to register opposition to OAI by voting against it, the legislator had to weigh the losses associated with its enactment against the losses that would be incurred by voting down the bundle and with it, federal relief funds. By increasing the number of politically appealing welfare programs (aid to mothers, the blind, and orphans) in the bundle, the president simply increased the likelihood of swinging opposition votes.

As an effort to restrict the scope of the legislative agenda, the ultimate check on this practice would have been a separate legislative vote on each title of the bill. Effectively utilizing the tie-in thus required the additional control over the agenda provided by the all-or-nothing offer. An all-or-nothing offer, in this context, was the implicit exchange of a legislator's vote for all items in the bundle or none at all. The legislator was thereby placed in the position of supporting the entire package as long as he assessed his position to be better than with none of the programs at all. As described by Abraham Epstein, a leading figure in the early social insurance movement, the omnibus nature of the legislation

> presented a real dilemma for earnest members of Congress. . . . They could not physically find the time to master the details of the many subjects involved in the bill. Nor could they place themselves in the same category with the anti-social members of Congress in opposing the entire bill. . . . Since their choice was all-or-none, they voted for all and left it to the Supreme Court to separate the good from the bad.[43]

The power behind the all-or-none offer lay in Roosevelt's clearly stated position (or threat) that the economic security bill was to be considered as a "unified," "comprehensive" bill and that the extension of welfare to the needy aged would be unacceptable without

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On the practice of tie-in sales in the public sector, see James M. Buchanan, "The Economics of Earmarked Taxes," *The Journal of Political Economy* 71 (October 1963): 457–69 and Richard Wagner and Warren Weber, "Competition, Monopoly, and the Organization of Metropolitan Areas," *Journal of Law and Economics* 22 (December 1975): 661–84.

See also Gordon Tullock, *The Politics of Bureaucracy* (Washington, D.C.: Public Affairs Press, 1965); William A. Niskanen, *Bureaucracy and Representative Government* (New York: Aldine-Atherton, 1971); and Ludwig von Mises, *Bureaucracy* (New Rochelle, N.Y.: Arlington House, 1969).

[43]American Association for Old-Age Security, "Social Security Bill Impractical," *Bulletin* 9 (June/July 1935): 11.

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the creation of the permanent social insurance program. This was made clear at several key points, such as when leaders of the Ways and Means Committee met with the president to determine whether (given the opposition to OAI) the omnibus character of the bill had to be kept intact: "The President informed them he wanted the whole bill passed and that OAI must stay in the bill."[44] When the Clark amendment was pending in the Senate, the White House assigned expert advisors to each of several key senators in order to influence the vote, then threatened to veto the entire Social Security bill in the event the amendment was adopted.[45] Witte assessed the situation:

> I doubt whether any part of the social security program other than the old-age assistance title would have been enacted into law but for the fact that the President throughout insisted that the entire program must be kept together. Had the measure been represented in separate bills, it is quite possible that the old-age assistance title might have become law much earlier. I doubt whether anything else would have gone through at all.[46]

In sum, the decisive factors for the emergence (the timing and the nature) of Social Security were: (1) an administration committed to the program and willing and able to use the powers of the office to see it enacted; (2) a network of advocates throughout the government and at the highest levels (such as Hopkins and Perkins), well schooled in social insurance and capable of doing the necessary "spadework"; (3) the presence of a popular and time-sensitive political commodity—relief funds for states and localities—the "sale" of which the administration could tie to compulsory old-age insurance; and (4) an economic crisis working to increase the uncertainty attached to the status quo—continued employment and private insurance as mechanisms for providing retirement income.

Some Implications for Reform

Admittedly, the huge wealth transfers effected by Social Security over the years have created two real obstacles to reform—a dependence among the elderly on the present system and perceptions among younger workers that high rates of return are sustainable. While these conditions tend to raise the cost of reform (particularly in the near term), they do not make reform impossible or even unlikely in the longer term. The "facts of the case" are what will condition long-term pressures for reform, and the relevant facts for evaluating Social

[44]Altmeyer, pp. 12, 34.

[45]Witte, *The Development of the Social Security Act*, p. 161.

[46]Ibid., pp. 78–79.

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Security as a vehicle for providing for one's retirement are that rates of return *are* falling and that the uncertainty of payoff in the distant future *is* increasing. Recent examples abound (the taxation of benefits and the increase in the retirement age, for example) whereby cuts in Social Security have been possible despite their apparent unprofitability for huge segments of the population.

In 1968, Buchanan suggested that given the opportunity to choose between the present system, with its "pie in the sky" features, and genuine insurance, the individual might well

> opt for a genuine insurance scheme which allows for considerably greater certainty about rates of return on what is genuine investment, both for the individual contributor and for the group of contributors collectively. He may do so even if he fully understands and accepts the argument that . . . the intergenerational tax-transfer mechanism may possibly secure for him a net advantage. The uncertainties may outweigh the differential in possible returns.[47]

Uncertainties, in other words, are what will make reform possible, even at a cost. Reforms that draw on now-familiar methods of supply (such as the expanded use of IRAs) will be particularly attractive.

In our present situation, radical reform of the social insurance system will require a committed administration and core of advocates. As revealed over the past three years, our governmental institutions and the people who staff them are considerably more responsive to revolutionary ideas when they expand the realm of government than when they contract it. Who is to say, however, that there will not be a confluence of forces that promote real reform? If the extreme (and costly) uncertainty about one's financial security in old age is recognized by an administration that has concrete ideas for expanding the options for young people, then—despite the transitional cost of reform—we could see real changes in our social insurance system.

[47]Buchanan, "Social Insurance in a Growing Economy," p. 389.

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"THE ECONOMICS AND POLITICS OF THE EMERGENCE OF SOCIAL SECURITY": A COMMENT

Edgar K. Browning

Professor Weaver's paper, and even more so her book, *The Crisis in Social Security,* contains a wealth of information on the political factors that led to and shaped the Social Security system.[1] One of the most fascinating conclusions of her work is that Social Security did not emerge out of a broad-based public demand for a federal retirement policy. Quite the contrary: Weaver shows that Social Security had its origins on the supply side of government and was hardly able to secure legislative approval. Despite having started from a position of little popular support, however, it is today regarded by the public as one of the most successful and popular social policies.

Social Security is far from unique in being a policy that the public was at first reluctant to accept and yet later embraced enthusiastically. The public school system is a similar example. As Professor E. G. West has shown, public schools were not initially demanded by the public; the pressure came from teachers who wanted security and favorable pay.[2]

Both the Social Security and the public-school examples—and others that could be mentioned—raise serious questions about the workings of the political marketplace. There is great political support for these policies today, yet there was little at their inceptions. Are

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The author is professor of economics, University of Virginia, Charlottesville, Va. 22901.

[1]*The Crisis in Social Security: Economic and Political Origins* (Durham, N.C.: Duke University Press, 1982) is a very informative and insightful study that contains much more supportive evidence for Weaver's position than could be included in her brief paper.

[2]See Edwin G. West, "The Political Economy of American Public School Legislation," *Journal of Law and Economics* 10 (October 1967): 101–28.

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these cases in which monopolistic public supply has created its own demand and thereby perpetuated itself? Or are these cases in which public supply, once in place, has demonstrated its superiority to private alternatives and has thereby come to win public approval? Both these positions are defensible, but the former—that public policies gain approval by virtue of being part of the status quo—raises the more serious roadblocks to meaningful reform. It suggests that policies become entrenched by creating powerful constituencies, making reform difficult. Weaver's work, I believe, tends to support this disheartening position.

Now let me turn to a consideration of some of the specific points raised in her paper. She begins by describing what she calls the "conventional wisdom" regarding the politics of Social Security. (As an aside, I would quibble with this characterization, because I think only a small minority of people accept this explanation of the way political factors influence the system.) The conventional wisdom is essentially a demand-side view of the political determination of policy: It holds that individuals weigh the benefits and costs they expect from Social Security and decide to support the system if they perceive net benefits. Thus, the conventional widsom will take widespread voter support for the system to be sufficient explanation for its existence.

The most interesting implication of the conventional wisdom is how it explains rational political support for the system even if it harms most people over the long run. The key to understanding this paradox is the fact that with a pay-as-you-go system it is always in the interests of older persons to continue or to expand the system. A person already retired, for example, will benefit from simultaneous increases in benefits and taxes (because retired persons will pay none of the taxes), even if that course harms all subsequent generations. And the later generations, when they grow older, will also favor continuation of the system. Society can become locked into perpetuating this chain-letter type of arrangement—no one wants to stop the process when he gets near the payoff (that is, as he grows older).

This is the conventional wisdom. Although Weaver acknowledges that the conventional wisdom "is vital for understanding the growth and evolution of Social Security," she argues that it "is inadequate for explaining the emergence, and, by inference, the reform of the system."[3] In other words, the system did not begin because of self-interested political pressure from voters, although that factor later played a role in the development of the system.

[3]Carolyn L. Weaver, "The Economics and Politics of the Emergence of Social Security: Some Implications for Reform," *Cato Journal* 3 (Fall 1983): 363.

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In tracing the emergence of Social Security, Weaver first documents the lack of popular support for the program and then shows how supply-side forces—bureaucrats, reformers, social workers, and so on—ultimately triumphed in 1935. I find this a generally convincing account of the thesis that supply-side factors played an important role, but I do not agree that those were the only factors involved. To develop this point, consider why there was so little public support for Social Security before 1935. Weaver finds the explanation in the "extreme uncertainty of payoff." People (especially younger people) were not really convinced the government would deliver the promised benefits. There is probably an element of truth in this, but I believe it is only part of a more general story. Remember that the 1930s were a period that saw the introduction of many government programs besides Social Security. That period was, in fact, the beginning of the welfare state. I think it is necessary to look for a general explanation for the growth of government in this period, and not just an explanation related exclusively to the specific characteristics of the Social Security program.

The explanation I prefer emphasizes two factors beyond those that Weaver stresses. First is the general leftward drift in ideological beliefs that took place in the early decades of this century. At that time, although the general public continued to believe in the principles of limited government and individualism, socialism and other doctrines critical of free enterprise became predominant in intellectual circles. This trend created a core of people in influential positions who were sympathetic to a more activist role for government—although they lacked the popular support necessary to put their ideas into practice. But then came the Great Depression. That traumatic experience further undermined the public's faith in free enterprise, and made people willing to accept almost any experiment that held out some promise of improvement.

So in the 1930s we had an intellectual climate favorable to expansion of government, combined with an economic catastrophe that conditioned the public to be receptive to drastic measures. It is easy to understand why Social Security (as well as a host of other government initiatives that would have previously been dismissed out of hand) secured legislative approval in this environment. My explanation is not offered as an alternative to Weaver's, but as a supplement to her analysis—neither uncertainty of payoff nor supply-side factors alone are sufficient to explain the emergence of Social Security. However, it seems clear that whatever the true cause of the emergence of Social Security in the 1930s, the conventional wisdom helps

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account for its rapid growth and its enthusiastic acceptance by the public.

What are the prospects for reform? At the end of her paper, Weaver is cautiously optimistic about the prospects for fundamental change. She emphasizes that the rate of return to Social Security is decreasing as we move out of the start-up phase and that uncertainty about future benefits is increasing, perhaps due to the demographic changes expected in the early part of the next century. However, according to the conventional wisdom, neither of these factors would lead to a rejection of the system. The "reduced returns" are average rates of returns over a lifetime—currently they include the windfall gains of early retirees. The relevant return from a political point of view, however, is the marginal return to changing the size of the system, and that return will remain very high for older people regardless of a (predictable) decline in the lifetime average return. For example, although future retirees may receive a low lifetime return, they will continue to support the system because curtailing it would have a negative marginal effect on their well-being.

Likewise, the uncertainty about future benefits does not appear to be important enough for the public to seriously consider radical reform. Much of the uncertainty has little factual foundation. Many people have been alarmed by talk of possible bankruptcy of the system, believing that in such a case benefits would cease altogether, but such an outcome is not possible. The problem is in mismatched revenues and outlays, especially in the next century, which will require a moderate (or substantial, under pessimistic assumptions about the future) reduction in benefits and/or increase in taxes. While the prospects are not rosy, they do not justify the fear that no benefits will be paid. Hence it is unlikely that the public will become fearful enough of benefits ceasing to support jettisoning the Social Security system.

In conclusion, the reasons given by Weaver for cautious optimism regarding the prospects for real reform are unsatisfactory. In conjunction with the general climate of opinion regarding the role of government in our society, the political forces that the conventional wisdom focuses on still operate too powerfully to allow us to achieve real reform.

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SOCIAL SECURITY: POLITICAL HISTORY AND PROSPECTS FOR REFORM

Edward J. Harpham

The past, historians remind us, holds the key to understanding the present. This is particularly true of the current problems confronting Social Security. The economic and political crisis that has undermined confidence in the Social Security system did not spring up overnight. It is the result of a long history of decisions that have been made over the past 50 years. To grasp the full significance of the problems confronting Social Security and the obstacles to real reform, it is essential that we understand the origins of the existing Social Security program.

Carolyn Weaver's paper provides us with an interesting perspective on this past. It attempts to explain why a pay-as-you-go system did not exist prior to 1935, and tries to account for those factors in the decision-making process that led to the creation of Social Security in 1935. Her paper, however, has certain limitations that weaken its usefulness as a guide to the political past of Social Security. By pointing out these limitations, I will try to provide additional insight into the political history of Social Security and the prospects for reform.

Uncertainty of Payoff

According to Weaver, "uncertainty of payoff" was one of the major reasons that a pay-as-you-go Social Security system did not emerge in the United States before 1935. In an unstable political and economic environment, workers had no guarantee that their participation in a pay-as-you-go system would pay off. Thus, Weaver argues, workers could have accepted the status quo (i.e., no social insurance

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The author is assistant professor of political science and political economy, the University of Texas at Dallas, Richardson, Tex. 75080.

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program) simply by calculating that the risk of losses in the present under the pay-as-you-go system more than offset the potential for gain.[1]

There is a certain appeal to Weaver's argument. One would expect that the issue of the uncertainty of payoff should have played a major role in undercutting support for a pay-as-you-go system. Such an explanation, however, does not fully account for why the United States did not have a Social Security program by the early 1930s while almost all other industrial societies did. By focusing on the issue of the uncertainty of payoff, Weaver tends to underestimate and even ignore other factors unique to the American experience that played a much more important role in preventing the emergence of a pay-as-you-go system.

For example, Weaver fails to consider important institutional barriers that prevented Social Security from being put on the agenda of the federal government prior to the Great Depression. One of the most important barriers was a limited constitutional government kept in check by a strong judiciary. Prior to the passage of the Social Security Act of 1935, welfare policy was an area traditionally left to the state and local governments. With relatively few exceptions, the federal government had refused to enact welfare legislation in the first 30 years of the 20th century and had left initiatives in such important areas as old-age pensions, workers' compensation, and unemployment insurance up to the states.[2] Many felt that Congress did not have the constitutional authority to enact such social insurance programs. Indeed, as late as 1937 many key policy makers believed that the Supreme Court would declare important portions of the Social Security Act unconstitutional. When the entire act, including the Old-Age Insurance program, was declared constitutional, policy makers were pleasantly surprised. Whatever the wisdom of the Supreme Court's final decision, the fact remains that it was not simply uncertainty of payoff that prevented the emergence of a pay-as-you-go system prior to 1935. Governmental institutions themselves were working under a set of rules and assumptions that tended to undercut and mute political support for such programs at the federal level.

Weaver also fails to consider how certain aspects of the political process affected the way in which voters' preferences got translated

[1]Carolyn Weaver, "The Economics and Politics of the Emergence of Social Security: Some Implications for Reform," *Cato Journal* 3 (Fall 1983): 371–72.

[2]For a discussion of early welfare and social insurance initiatives at the state level prior to 1935, see Roy Lubove, *The Struggle for Social Security: 1900–1935* (Cambridge, Mass.: Harvard University Press, 1968).

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into public policies in the early decades of the 20th century. In order to understand why a particular policy was or was not enacted by the federal government, one needs to know not only voter preferences but also how interest groups tended to translate their self-interest (preferences) into concrete policy proposals. In this regard, the political position of organized labor on Social Security is particularly revealing. Surprisingly, organized labor did not play a major role in the passage of the Social Security Act. Indeed, the American Federation of Labor (AFL) did not have a fixed position on social insurance issues until the early 1940s. From its establishment in the late 19th century until the 1930s, the leadership of the AFL was committed to "volunteerism"—the belief that employment issues were settled best by collective bargaining free from government interference. While the AFL did support the passage of the Social Security Act of 1935, it did so with little enthusiasm.[3] Much like the question of constitutionality, organized labor's commitment to volunteerism tended to work against the emergence of a political coalition in favor of any social insurance programs.

One could argue, of course, that the issues of constitutionality and of labor volunteerism simply contributed to the uncertainty of payoff confronting rational voters deciding whether to support a pay-as-you-go system of social insurance. This line of argument, however, points to what is perhaps the most disturbing aspect of Weaver's paper: The assumption that a pay-as-you-go Social Security program was an issue that confronted both voters and policy makers prior to 1935. Such an assumption is difficult to accept, particularly in light of the political controversies surrounding the actual passage of the Social Security Act. The pay-as-you-go system that exists today did not emerge in its final form until 1950—15 years after the passage of the original Social Security legislation. It was the product of a long history of debate among policy makers as to how Social Security should be funded over the long run.

The Debate over Financing

The Committee on Economic Security (CES) originally considered both "full reserve" and "pay-as-you-go" approaches to financing Social Security.[4] Under the full-reserve approach, initial benefits being paid

[3]See Martha Derthick, *Policymaking for Social Security* (Washington, D.C.: Brookings Institution, 1979), pp. 110–13.

[4]See Derthick, pp. 228–30; Jerry R. Cates, *Insuring Inequality: Administrative Leadership in Social Security, 1935–54* (Ann Arbor: University of Michigan Press, 1983), pp. 40–44; Arthur J. Altmaier, *The Formative Years of Social Security* (Madison: University of Wisconsin Press, 1968), pp. 10–11; Edwin E. Witte, *The Development of the Social Security Act* (Madison: University of Wisconsin Press, 1963), pp. 146–61.

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out would have been low and based on contributions to the system. In addition, a reserve of $50 billion to $60 billion would have been accumulated to meet future payouts. Under the pay-as-you-go approach, on the other hand, initial benefits would have been high and financed over the long run by supplementing payroll taxes with general revenues. The reserve would have been kept at a minimum.

The final plan recommended by the committee to Roosevelt was a modified-reserve approach that provided for the accumulation of a "partial contingency" reserve of $10 billion and for higher initial benefit payments for older workers. Younger workers, meanwhile, were to receive benefits based upon their contributions to the system as if the system operated fully on actuarial principles.[5] The committee recognized that by 1965, general revenues would have to be used to supplement payroll taxes. However, the committee argued that because the need for the Old-Age Assistance Program (a state/federal program included in the Social Security Act) would have dwindled to almost zero, general-revenue monies would be available for subsidizing the social insurance program.

It is significant to note that considerable confusion surrounded the benefits provisions in the original CES proposal. As Edwin Witte, the executive director of the committee, pointed out: "[N]o member of the committee understood that payments in excess of contributions would be made not only to workers already approaching old age, but to substantially all workers who entered employment prior to 1957."[6] It appears that Roosevelt also suffered from such a misconception. Initially Roosevelt believed that the committee's plan contemplated higher benefits only for those workers approaching old age who did not have the time to build up adequate old-age credits. When he discovered that his understanding of the program did not conform with the actual proposed program and that the large deficits projected after 1965 were to be funded with general revenues, he demanded that new tax rates and benefit formulas be developed to make the program self-supporting.[7] In the end, the committee's proposals were amended to be more along the lines of the full-reserve approach. The initial tax rate was to be 1 percent on employers and employees from 1937 to 1939 and was then to rise .5 percent every three years, until a maximum of 3 percent on both employers and employees was

[5]See Cates, p. 42; Theron F. Schlabach, *Edwin E. Witte: Cautious Reformer* (Madison: State Historical Society of Wisconsin, 1969), pp. 126–28.

[6]Witte, pp. 148–49.

[7]Ibid.; see also Cates, pp. 40–44.

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reached in 1949. Initial benefits were to be lower than in the original plan. Actuaries calculated that under this arrangement the system would accumulate a reserve of approximately $50 billion and would be self-supporting at least until 1980.[8]

Interestingly, Roosevelt found himself backing off from the full-reserve method within four years.[9] Almost immediately after the passage of the act, a heated partisan debate developed over the financing of the Social Security program. Some critics protested the initial low benefits provided retirees. Others criticized the payroll-tax mechanism. Still others were fearful of the large accumulation of funds in the hands of the federal government. The debate culminated in the passage of the Social Security Amendments of 1939. The amendments effectively shattered the linkage that had been forged between taxes and benefits in the original full-reserve program. They provided for supplemental benefits for dependents and survivors of covered workers, the beginning of benefit payments in 1940 rather than 1942, and the basing of benefit rates upon monthly wages rather than cumulative wages. They also postponed the .5-percent payroll-tax increases scheduled for 1940 until 1943.

In short, the Social Security Amendments of 1939 transformed Social Security from a self-supporting insurance program based in large part on a full-reserve approach into a system of transfer payments geared to present welfare concerns. The amendments did not, however, formally establish the pay-as-you-go system that we are familiar with today. Throughout the 1940s, the payroll-tax rate remained frozen. Few in Congress were willing to support tax increases whose current need could not be demonstrated. Little attempt was made to grapple with the question of the long-term financing of the program. Not until 1950 was a new linkage actually forged between payroll taxes and benefits. This linkage was qualitatively different from what was originally envisioned by either the CES or Roosevelt.

In light of this brief history of Social Security, Weaver overstates the argument that uncertainty of payoff played a primary role in explaining the reluctance of many individuals to support a pay-as-you-go system of social insurance. Such an issue could not be raised in any coherent manner until the long-term financing of Social Security had been resolved in 1950. However important the issue of the uncertainty of payoff in a pay-as-you-go system is for workers today, it is a mistake to believe that it was an issue of paramount importance in the early decades of the 20th century.

[8]Witte, p. 151.

[9]For a more detailed discussion of what follows, see Derthick, pp. 237–44.

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There were important political questions surrounding the financing of an old-age retirement system that were of vital importance to workers and voters. Moreover, some of these were closely related to the question of certainty of payoff. For example, Roosevelt favored a contributory system of social insurance financed through the payroll tax because he believed it would make the payment of benefits more certain. Individuals would feel that they had earned a right to Social Security benefits through their payroll-tax contributions, and the government would be placed under a certain obligation to make sure that those benefits were paid. Significantly, Weaver has analyzed some of these political questions in her excellent book, *The Crisis in Social Security: Economic and Political Origins.*[10] Unfortunately, by focusing her discussion in this paper on the larger theoretical implications of the pay-as-you-go model, she has failed to discuss such concrete historical issues in sufficient detail.

Despite the limitations of Weaver's general discussion of uncertainty in the pay-as-you-go model, the paper has much to teach us about the policy-making process that gave us the Social Security system. Weaver points out how social-insurance experts were able to control the flow of information into the policy-making process and as a result, how they were able to dominate the agenda with their own proposals. She also explains how the comprehensive approach (to problems of welfare) found in the Social Security Act of 1935 made the passage of particular programs, such as the Old-Age Insurance program, easier. In short, she outlines the conditions that made Social Security possible at a time when many individuals were hostile to any federally sponsored social insurance program.

The Limits on Reform

Do the conditions exist for a substantive reform of the Social Security system? This question, which follows from Weaver's discussion of the passage of the Social Security Act, is of vital importance to us today. Although Weaver believes that such reform is possible, I believe that her paper suggests why it is not. In sharp contrast to 1935, no one group of individuals controls either the information going into the decision-making process or the agenda. The virtual monopoly that social-insurance experts and advocates have had over Social Security policy making since 1935 has been challenged on various fronts since the early 1970s. Far from leading to more open policy making, however, the opening up of the debate over Social

[10](Durham, N.C.: Duke Press Policy Studies, 1982).

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Security appears to have overloaded the decision-making process. Legislators do not seem to be very interested in substantively reforming Social Security; rather they seek to suppress meaningful reform and defuse the issue until the next election is past. If the 1983 reform package is any indication of what is to come, there is little hope for more than marginal changes in the Social Security system.[11]

The likelihood of fundamentally restructuring Social Security thus does not appear great in the near or the foreseeable future. This does not mean that the issue of Social Security reform will go away like some bad dream. Indeed, it might return to haunt us time and again over the next 45 years. The 1983 reforms provided only a small reserve margin to get through the late 1980s. Even a brief economic downturn could throw the entire issue of funding Social Security back into the public arena. Moreover, potentially massive liabilities face the Medicare program if nothing is done to cope with rising health costs in the next few years. Finally, despite the modest benefit cuts of the 1983 reforms, the long-term problem of an aging population still looms.

[11]For a larger discussion of the significance of the 1983 reforms, see Edward J. Harpham, "Fiscal Crisis and the Politics of Social Security Reform," in Anthony Champagne and Edward J. Harpham, eds., *The Attack on the Welfare State* (Prospect Heights, Ill.: Waveland Press, 1984).

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SOCIAL SECURITY: MYTHS AND REALITIES

Paul Craig Roberts

Shortly after the inauguration, the Reagan administration faced a crisis in Social Security, despite the 1977 amendments that President Carter promised would make Social Security sound through the turn of the century. The largest of the system's three programs, Old-Age and Survivors Insurance (OASI), was likely to run out of money during Reagan's term of office unless economic growth proved robust. The long-run prospects of the combined system (OASDHI) included large perpetual deficits and were even more dismal.

The Treasury recognized that Social Security was an unfunded system of taxes and transfer payments that was unaffordable at the current rate of growth in benefits, and the Office of Economic Policy developed a plan for putting Social Security on a realistic basis. However, other parts of the government had different goals, and the opportunity was lost. The Office of Management and Budget concentrated on short-run budget savings in order to lower current federal budget deficits. The Department of Health and Human Services was preoccupied with its effort to rid the system of various welfare elements. Robert Myers and the Social Security Administration were determined to keep Social Security on an expanding course as the main source of retirement income. As a result the Treasury was frustrated in its effort to focus attention on the realities of the system. Instead, the myth that Social Security is an affordable pension system was perpetuated, and a new myth was born—that the government will deal responsibly with the long-run Social Security problem.

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The author holds the William E. Simon Chair in political economy at the Center for Strategic and International Studies, Georgetown University, Washington, D.C. 20006.

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The Source of the Problem: The 1972 Social Security Amendments

There are two major areas of Social Security that involve indexes. The one most people think of is the annual cost-of-living adjustment (COLA), which occurred each July 1 until the 1983 Social Security Amendments moved the date to January 1. This adjustment increases benefits going to current retirees by the amount of inflation each year, as measured by the consumer price index. Thus, whatever benefit the worker receives upon first retiring is preserved in real terms and protected from inflation. This cost-of-living adjustment is often blamed for the deficits in the Social Security accounts and the overall federal budget, but it is not the real culprit.

The other area of indexing is the real source of the system's long-run troubles. When a worker retires, the amount of his first Social Security check, or initial benefit, is computed by a formula that involves wage indexes. These indexes cause the real value of each retiring generation's initial benefits to rise over time. The COLA merely preserves the real value of these benefits over the individual's retirement period. It is the buildup of the real levels of the *initial* benefits, generation after generation, that is leading to the system's ruin.

Prior to the 1972 amendments, Congress had raised Social Security benefits over the years on an ad hoc basis. However, a 15-percent benefit increase in 1970, a 10-percent increase in 1971, and a 20-percent increase in 1972 represented quantum jumps in benefit levels. These were reinforced by the 1972 Social Security Amendments, which were supposed to preserve these increases with automatic inflation adjustments each year, beginning in 1975.

Unfortunately, the 1972 amendments contained a major formula error, which has become known as the "double indexing" or "decoupling" problem. It resulted in sharp increases in benefits for new retirees just entering the system and caused benefits to rise faster than wages. An average worker retiring in 1969 could expect to receive a tax-exempt Social Security benefit equal to 31 percent of his last working year's gross income. By 1972, ad hoc increases by the Congress raised this so-called "replacement rate" to 38 percent. As a result of the automatic adjustments in the 1972 amendments it rose to 41 percent in 1974, 44 percent in 1976, and 55 percent in 1981.[1]

[1]These historical replacement rates are taken from unpublished tables prepared by the Office of the Actuary, Social Security Administration, August 1981.

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The source of the problem was fairly straightforward. The initial Social Security benefit a worker received upon retiring was computed in two steps. First, the worker's gross wages from 1951 until the date of retirement were added up and averaged over the number of months worked to determine an average monthly wage. This wage, split into several "brackets," was then multiplied by an array of percentages called the "marginal benefit rates," which were set by law. The product was the worker's initial Social Security check. For example, if the benefit rates averaged 0.40, then the worker's first retirement check would equal 40 percent of his average wage. The 1972 amendments provided for the annual adjustment of the marginal benefit rates for each year's population of retirees by the amount of inflation over the year. For example, if inflation had been 10 percent and the old benefit rates had averaged 0.40, the new benefit rates would average 0.44. Unfortunately, complete adjustment of the benefit rates for inflation overadjusted benefits. Over time, wages tend to rise with inflation. While wages earned in the distant past were, of course, not adjusted for recent inflation, wages earned in the years immediately preceding retirement would have been largely adjusted for inflation. Consequently, one part of the benefit computation, the average monthly wage, was already partially adjusted for inflation by the marketplace.

The correct way to increase the product of two numbers by, for example, 10 percent is to increase one number or the other number by 10 percent, but not both. By adjusting the benefit rates completely when the average monthly wage had already received partial adjustment for inflation, the formula made the resulting benefits grow faster than inflation.

The Perpetuation of the Problem: The 1977 Social Security Amendments

The 1977 amendments stopped the initial benefits from rising faster than wages but allowed the initial benefits of each retiring generation to keep pace with real wages over time. This was not enough of a reduction in benefit growth to deal with the long-run problem.

The modifications made in 1977 left the system on a path of expansion that will carry outlays significantly beyond currently scheduled tax rates. Under the economic assumptions (Alternative II-B) in the 1982 Trustees Report, OASDI benefits were scheduled to rise as a percent of payroll from between 10 percent and 12 percent near term to between 17 percent and 18 percent long term. This compared with

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a scheduled OASDI long-term tax rate of 12.4 percent of payroll after 1990. After a few years of surplus, beginning in the 1990s, a deficit appeared shortly after the year 2010, widening to a permanent gap of roughly 5 percent of payroll between outlays and receipts in OASDI after the year 2025.

Adding in Hospital Insurance (HI) makes the deficit worse. The combined OASDHI system's outlays were projected to rise as a percent of payroll from 15 percent near term to between 27 percent and 30 percent long term. This compared with the scheduled OASDHI long-term tax rate of 15.3 percent after 1990. A deficit appeared shortly after 1995, widening to a permanent gap of roughly 12 to 15 percent of payroll between outlays and receipts in OASDHI after the year 2025. This translated into an annual deficit in excess of $300 billion by 2025 and in excess of $600 billion by 2060, measured in real 1983 dollars.[2]

The source of the long-run deficits is twofold. First there are the demographics. As the population grows more slowly over time, the population ages, and there are more retirees per worker. Second, the indexing formula allows initial benefits to grow indefinitely in real terms at the same pace as wages. With real benefits per retiree rising along with real wages, but with the number of retirees rising faster than the number of wage earners, the cost of the system must rise as a percent of payroll. Consequently, either payroll-tax rates must rise sharply, taking more out of each dollar of wages, or the growth of real benefit levels must be reexamined.

The Social Security system is in crisis because it is scheduled to pay ever-rising real benefits to successive generations. One way to deal with the problem is to reduce the scheduled rise in benefits. A switch from wage indexing (under which real benefits per retiree would triple in three generations) to price indexing (under which real benefits per retiree would roughly double) would essentially eliminate the long-run OASDI problem.

Price indexing was recommended in the 1976 Hsiao report.[3] The Finance Committee under Senator Long was receptive to the proposal. The Treasury, led by Secretary William E. Simon, was also eager to take the more responsible course. However, there was an

[2]*1982 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds,* House Document No. 97-163, 97th Cong., 2d sess., April 1, 1982, table 27, p. 64.

[3]See William C. Hsiao, "An Optimal Indexing Method for Social Security," in Colin D. Campbell, ed., *Financing Social Security* (Washington, D.C.: American Enterprise Institute, 1979), pp. 19–40.

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election approaching. President Ford, at the apparent urging of his political advisors and with the apparent blessing of his chairman of economic advisers, Alan Greenspan, wished to appear more generous. Ford opted for the much more expensive wage-indexing procedure. This single mistake added well over $2 trillion in unfunded liability in present-value terms to the system's long-run deficit. It accounts for more than 100 percent of OASDI's deficit.

The Misleading Concept of Actuarial Balance

The long-run problem is hidden by a misleading statistic. It is called the "actuarial balance" of the OASDI system. (The HI portion is generally excluded.) The Social Security Administration (SSA) generally reports on the condition of the OASDI trust funds over a 75-year future planning period. It says the system is in "actuarial balance" if the average income of the system measured as a percent of payroll equals the average cost of benefits measured as a percent of payroll over 75 years. In 1982, the OASDI system was reported to have a deficit of 1.8 percent of payroll. In other words, the system needed a tax rate 1.8 percent of payroll higher on average over 75 years than was scheduled in the law, to match promised benefits.

This "average" gives the impression that raising tax rates or cutting benefits by 1.8 percent of payroll would make the system financially sound. This was the theory that guided the recent National Commission. But nothing could be further from the truth.

The year-by-year surpluses and deficits in the system are not uniformly spread over the 75-year planning period. Neither are projected receipts roughly in line with projected outlays decade by decade. Instead, the surplus years all fall roughly between 1990 and 2010, with widening deficits thereafter. The SSA was relying on the buildup of a large trust fund between 1990 and 2010, which would be drawn down after 2010 to cover the long-term deficit until the money ran out (between 2030 and 2040). What was the system to do then, when it would suddenly face annual outlays 5 or 6 percent higher than annual receipts, with no trust fund to pay the difference?

In fact, the OASDI surpluses either would be spent by Congress or would have to be borrowed to finance HI deficits in the 1990s, and the whole OASDHI system would be bankrupt by about 2015. It would then face ongoing annual deficits of 12 to 15 percent of payroll under the 1982 Trustees Report II-B assumptions. (The 1983 Social Security legislation did not significantly alter these prospects, particularly if the Census Bureau's new lower fertility and population estimates are employed in the calculations.)

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With or without HI, the 75-year average is merely camouflage for a deteriorating system. Only if the system is brought roughly into balance on a year-to-year basis can it be permanently fixed. This balancing means either slowing the growth rate of real benefits and raising hospital insurance premiums and deductibles for future retirees so that benefits only rise to 15 percent of payroll (the currently scheduled 1990 tax rate), or else roughly doubling the payroll tax to match the growth of benefits.

This fundamental imbalance in the system is largely hidden by the 75-year summary statistic. A 75-year average moves very slowly from one year to the next. Nonetheless, as each year goes by, the summary statistic decays a bit. As the planning period shifts forward, a year of near-term surplus goes by and a year of long-term deficit is added. For example, in 1985, the planning period will run from 1985 to 2060. The year 1985 will show a surplus, 2060 a deficit. In 1986, the planning period will be 1986 to 2061. The surplus year 1985 will fall out of the average, and the deficit year 2061 will be rolled in. The result is a deterioration in the system's "balance."

Every year in the Trustees' Report, the SSA gives a list of reasons for any year-to-year change in the summary statistic. These reasons include changes in economic and fertility assumptions. One reason that appears every year is "change in valuation period." This is the admission that the 75-year average is not stable. It is a moving average that was headed toward a basic deficit of 5 or 6 percent of payroll for OASDI and 12 to 15 percent of payroll for OASDHI, under the 1982 assumptions.[4] This is why the summary statistic is a poor measure of what needs to be done for the system. This is why the tables showing the annual deficits in the system over time and the pattern that is emerging provide the only meaningful way to view the system. Bringing forward payroll-tax increases already scheduled, as was done in the 1983 Social Security bill, reduces the system's long-run deficit as measured by the summary statistic. But such steps do nothing to improve the system's real balance over time.

As long as the summary statistic is used as a guide to policy, we will have periodic crises in the system. Each time the trust funds start to run out, the summary statistic will be "balanced" by some short-run transfers and tax-rate increases. Near-term benefits will be cut very little, both because it is not fair to cut benefits without adequate warning and because current retirees are active voters. This

[4]Under the 1983 amendments, the deficit is projected at 2 to 3 percent of payroll for OASDI and at 8 to 9 percent of payroll for OASDHI. The deficit would be larger if the calculations were based on the Census Bureau's fertility estimates.

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process will be enough to bring the 75-year average into "balance" with short-run surpluses and long-run deficits. Then since the system is apparently in balance, why do anything to bring long-run benefit growth under control? And nothing is done until the next crisis, when it is again too late to touch benefits.

The President's Goals Defeated

The 1983 Social Security legislation was a defeat for the president's Social Security goals. Little was done to improve the long-run prospects of the system. Instead, Reagan was forced to accept an enlarged system, which he had eloquently opposed in the past. Coverage was extended to new federal workers and employees of nonprofit organizations, and state and local governments were prohibited from withdrawing from the system. The increase in the payroll-tax rates was partly offset out of general revenues by such measures as an income tax credit. The result is a combination of higher tax rates and general revenue transfers, neither of which the president wanted.

The taxation of half of Social Security benefits as provided in the 1983 amendments introduced a means test into the system for the first time. Worse yet, the method of taxing the benefits was totally inconsistent with the president's desire to increase the incentives to work, save, and invest.

The correct way to tax half of Social Security benefits is simply to add half of the benefits to taxable income. If it is desired to give people with lower incomes special treatment and reduce their burden, part of the benefits could be excluded from tax, with only the benefits in excess of the exclusion entering taxable income. This method may push a recipient into a higher tax bracket, but the resulting disincentive would be mild compared to the way the proposal was actually implemented.

As recommended by the commission, the method of taxing half of benefits was a farce. The commission proposed that a single retiree with $20,000 ($25,000 for a married couple) in outside income from savings, private pensions, or wages be required to add half of his Social Security benefits to his taxable income. A single retiree earning $19,999 would pay no tax on his Social Security benefits. A single retiree earning $20,000 would have to add perhaps $4,000 to taxable income and pay nearly $1,000 in additional tax. That is an expensive dollar of income. The marginal tax rate would have been 100,000 percent.

After loud complaints about the commission's proposal, the House version of the bill took away part of the problem and left merely a

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major disaster. The House phased in the taxation of half of Social Security benefits as other income exceeds certain thresholds. Like the commission's blunder, this action has the effect of raising the marginal tax rate on other income. But the effect is less spectacular: The marginal tax rate on income of Social Security recipients increased 50 to 77 percent. The Republican Senate could not wait to join the House in delivering this punishing blow to a major Republican constituency—retired people with a median income or higher. One Republican senator (Chafee) even got an amendment passed that included tax-exempt interest in the income measure used to determine whether the taxpayer's income exceeded the threshold! The senator was determined that no old person who had managed to save anything for his retirement would escape the net.

The result of the 1983 Social Security legislation was to move a retired individual with $26,000 in private retirement income from a 30-percent marginal tax rate to a 45-percent rate. A retired couple with a private retirement income of $38,000 was moved from a 28-percent to a 50-percent marginal tax rate. Social Security recipients with private retirement income who are still working and have "earned income" in excess of the Social Security earnings limitation can face marginal tax rates in excess of 100 percent until 1990.

To understand how this happens, consider the case of the single retiree currently in the 30-percent bracket. Since his private income is above the allowable threshold, his Social Security income is subject to tax. For every dollar in private income above the threshold, he has to pay tax on 50 cents of Social Security income until he is paying tax on one-half his Social Security benefits.

In other words, above the threshold, every dollar of private income results in $1.50 of additional taxable income. That raises the tax rate on his additional dollar of private income by half, from 30 cents to 45 cents ($1.00 × .30 + $0.50 × .30). The increase in the tax rate may be even higher if the added income pushes him up a bracket. This continues until one-half of the benefits are taxed, at which time the effective marginal tax rate drops back down.

This approach to the taxation of Social Security benefits makes little sense, and it is inconsistent with President Reagan's desire to lower marginal tax rates and to increase saving and investment. Once people planning their retirement realize that the penalty for providing a private retirement income in excess of the threshold is to be hit with 50-percent to 77-percent increases in marginal tax rates, their saving rate is likely to drop. The result will be to make people more dependent on Social Security, thereby worsening the long-run problem.

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The horror story worsens when you consider the interaction of the taxation of benefits with the existing limitation on earned income, which costs retirees one dollar in reduced Social Security benefits for every two additional dollars earned by continuing to participate in the work force. This is equivalent to an additional tax of 50 percent on additional earnings, over and above the marginal federal income tax rate. In this case, due to the loss of benefits, many retirees will experience marginal tax rates on additional earned income in excess of 90 percent. If payroll and state income taxes on additional earned income are taken into account, the marginal tax rates can exceed 110 percent. One has to ask: What happened to the Reagan administration that was going to improve incentives for people to work?

Senator Armstrong got the Senate to adopt an amendment to repeal the earnings limitation, but the Senate delayed the repeal until the 1990s. The House, however, insisted on retaining the earnings limit. The final compromise lowered the loss-of-benefit penalty for exceeding the earnings limitation from one dollar in reduced Social Security benefits for every two dollars earned above the limit to one dollar for every three dollars. This dropped the implicit tax on "excess earnings" from 50 percent to 33 percent, bringing the maximum tax rates faced by a retiree who continued to participate in the work force down from around 110 percent to the range of 83 to 98 percent.

What we have here is a form of age discrimination that perhaps manages to avoid technically violating the antidiscrimination laws but nonetheless violates the spirit of the law. The entire thrust of the Social Security package is to deny the aged any incentive for being independent of the government.

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THE NATIONAL COMMISSION'S FAILURE TO ACHIEVE REAL REFORM

A. Haeworth Robertson

Introduction

On January 20, 1983, the National Commission on Social Security Reform released its long-awaited report, discharging its mandate to identify Social Security's financial problems and propose "solutions to such problems that will both assure the financial integrity of the Social Security System and the provision of appropriate benefits."[1] This report was duly presented on February 1, 1983, to the Committee on Ways and Means of the United States House of Representatives.

The work of the National Commission on Social Security Reform was extremely disappointing. Not because it failed to make recommendations that would resolve all of Social Security's financial and design problems—that would be asking too much. But because it failed to identify and report forcefully the full extent of the problems so that Congress and the public would know that such problems exist. This failure to be honest and forthright with the public, if not corrected, will result in the continued erosion of public confidence—not only in Social Security but in the government itself.

Summary of Major Provisions

The major provisions of the Commission's compromise proposal to resolve Social Security's financial problems are as follows.

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The author was formerly chief actuary, Social Security Administration, and is now managing director of William M. Mercer, Inc., Washington, D.C. 20016.

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[1]*Report of the National Commission on Social Security Reform* (Washington, D.C.: Government Printing Office, January 1983), chap. 1, p. 2.

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1. The Social Security tax on employers and employees would be as follows:

1983	6.70%
1984	7.00
1985	7.05
1986-87	7.15
1988-89	7.51
1990	7.65

In effect, this means higher taxes in 1984, 1988, and 1989 than scheduled under present law. In 1984 only, the worker would be allowed a refundable tax credit equal to the entire increase (0.30 percent) in Social Security taxes.

2. The Social Security tax for Old-Age, Survivors, and Disability Insurance (OASDI) levied on self-employed persons would be increased from three-fourths of the combined employer-employee rate to the full employer-employee rate. Half of the total payment could be deducted from taxable income for income-tax purposes, but not for purposes of determining the OASDI and HI (Hospital Insurance) tax. Many self-employed people would thus pay a higher net amount of Social Security and income taxes.

3. The annual cost-of-living adjustment, now paid in July, would be postponed this year (1983) until next January and then paid each January. The change would affect all 36 million beneficiaries. A special provision would reduce the impact on low-income elderly and disabled persons who are also receiving welfare payments.

4. Half of a person's Social Security benefits would be subject to federal income tax, but only if he had adjusted gross income of at least $20,000 from sources excluding Social Security, or in the case of a married couple filing jointly, if they had $25,000. Proceeds of the income tax would be paid into the Social Security (OASDI) trust funds. Some 3 million people, or about 10 percent of the OASDI beneficiaries, would pay extra taxes under this provision.

5. As of January 1, 1984, mandatory Social Security coverage would be extended to all new federal workers. It would also be extended to all employees of nonprofit organizations, for whom participation is now optional. Federal workers who are covered by the Civil Service Retirement System would not be affected. It is anticipated that the government would establish a supplementary employer pension for new federal employees, so they would end up receiving Social Security plus a supplementary pension (as is now the case with many private-sector workers).

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6. Local and state governments covered by Social Security would be prohibited from opting out as of the date of enactment of the proposed plan, unless the process of termination is completed by such date.

7. The so-called windfall portion of Social Security benefits received by federal, state, and local government employees who qualify for Social Security on the basis of relatively short periods of employment in the private sector would be eliminated for the first people who would be eligible to retire after 1983. They would receive a benefit, but less than under current law.

8. Beginning in 1988, the plan would seek to stabilize the trust funds by providing that whenever the combined OASDI trust funds drop to less than one-fifth of a year's benefits, the annual cost-of-living adjustment would be equal to either the annual rise in prices or the annual rise in wages, whichever is less.

9. From 1990 to 2010, the plan would phase in a larger bonus, equal to 8 percent a year instead of the current 3 percent, for each year a person delays retirement after age 65 and before age 70.

10. The trust fund would be reimbursed by the Treasury for free wage credits granted to military personnel in the past and for uncashed Social Security checks.

11. Benefits and eligibility would be improved for certain types of widows and widowers, divorced persons, and survivors.

12. In the case of salary-reduction plans qualifying under Section 401(k) of the Internal Revenue Code, any salary reduction thereunder would not be treated as a reduction in the wages subject to OASDI taxes.

Financial Aspects of Recommendations

Ignoring the merits and faults of the Commission's recommendations for a moment, how effective are the recommendations in resolving Social Security's financial problems? Unfortunately, they are not very effective.

During its meeting (November 11–13, 1982), the Commission adopted a background book of actuarial cost estimates for OASDI and HI. These estimates defined the size and scope of Social Security's financial problems as follows.

- During the 1983–89 period, provision will have to be made to increase OASDI income or decrease benefits, or some combination of both, by $150 billion to $200 billion (that is, by 9 percent to 12 percent of projected OASDI expenditures).

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- During the 75 years from 1982 to 2056, the average annual OASDI deficit (defined by comparing income and outgo according to the intermediate [II-B] demographic and economic assumptions used in the 1982 Trustees Reports), would be equal to average annual expenditures of 14.09 percent of taxable payroll and average annual tax income of 12.27 percent of taxable payroll. This would yield an average annual deficit of 1.82 percent of taxable payroll.
- During the 1983–89 period, scheduled taxes will be barely adequate to pay HI benefits; increased taxes or decreased benefits for HI must be adopted no later than 1990. Under less optimistic assumptions, this remedial action must be taken in the late 1980s, and even sooner if OASDI continues to borrow from HI.
- During the 75 years from 1982 to 2056, the average annual HI deficit (defined by comparing income and outgo according to the intermediate [II-B] demographic and economic assumptions used in the 1982 Trustees Reports), would be equal to average annual expenditures of 8.10 percent of taxable payroll and average annual tax income of 2.89 percent of taxable payroll. This would yield an average annual deficit of 5.21 percent of taxable payroll.

The Commission's recommendations attempt to assure the near-term solvency of the OASDI program by increasing projected net income during the 1983–89 period by $168 billion (primarily by increasing taxes by $129 billion and decreasing projected benefit increases by $40 billion). This would satisfy the requirement stated above, that net income be increased by $150 billion to $200 billion.

The Commission's recommendations would decrease the average 75-year OASDI deficit of 1.82 percent of taxable payroll to 0.58 percent, thus eliminating only about two-thirds of that deficit. No agreement could be reached by the Commission on how to eliminate the remaining deficit. Some members favor a higher retirement age, some prefer higher taxes, and some prefer reduced benefits.

The Commission virtually ignored the HI deficit of 5.21 percent of taxable payroll, which is almost three times the OASDI deficit of 1.82 percent. The Commission also completely ignored the Supplementary Medical Insurance (SMI) part of Medicare, 25 percent of which is financed by premiums paid by participants and 75 percent of which is financed by general revenue. The total cost of SMI is now the equivalent of about 1 percent of taxable payroll, and is projected to rise to some 5 percent of taxable payroll during the lifetime of today's youth.

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There is nothing mysterious about Medicare; and there is no excuse for ignoring it. It is a life annuity, paid in kind rather than cash, primarily to Social Security beneficiaries age 65 and older. Almost one-fifth of the taxpayer's FICA (Federal Insurance Contribution Act) tax is now used to finance the HI portion of Medicare. Medicare is a part of Social Security; ignoring Medicare's problems will not make them disappear.

Although the Commission did not address the financial problems of the HI program, and in spite of that program's imminent financial difficulties, the Commission recommended that the OASDI trust fund be authorized to continue borrowing from the HI trust funds during the 1983–87 period.

The Commission's recommendations, therefore, do not even come close to resolving Social Security's financial problems—except those of the OASDI program for the next seven years.[2] To resolve the longer range financial problems, the tax rate would have to rise considerably above its currently scheduled level of 7.65 percent in 1990.

Under "intermediate" assumptions (adopted by the Commission), the tax rate would have to increase to about 14 percent early in the next century (within the working lifetime of today's young taxpayers). This is nearly twice the ultimate scheduled tax rate of 7.65 percent. And under less optimistic assumptions, the tax rate would have to increase to about 20 percent (a combined employer-employee tax rate of 40 percent). This is almost three times the ultimate scheduled tax rate of 7.65 percent.[3]

This tax increase is in addition to the cost of the Supplemental Medical Insurance (SMI) part of Medicare, which is projected to rise to some 5 percent of payroll and is financed primarily from general revenue.

There are alternatives, of course, to these onerous tax rates. The retirement age could be increased to about age 70 for persons under

[2]Under less optimistic (but not inconceivable) economic assumptions, the Commission's recommendations would fail to sustain the OASDI system through the 1980s, and further remedial action would be required.

[3]For long-range planning purposes, it appears prudent to rely upon demographic and economic assumptions that are less optimistic than those adopted by the Commission. For example, the Commission's intermediate assumptions are that the fertility rate will eventually rise about 12 percent above its present level. The latest official population projections by the Bureau of the Census, however, indicate that a better assumption to use for planning is that fertility rates will not rise above current levels.

By assuming higher-than-realistic fertility rates, the Commission is assuming lower-than-realistic future costs. It is wishful thinking to assume that fertility rates will rise above current levels and to make future promises of benefits on that basis. All indications are that fertility rates will remain at their present levels or else decline.

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age 35, or benefits for future retirees could be reduced somewhat, or the entire system could be restructured to reflect the changing social and economic environment. But the Commission could not consider changes of this type without acknowledging a longer range problem—and this it failed to do.

The Commission considered it a major achievement that it could get the minority of the commissioners representing those who favor the status quo to admit there will be a relatively minor financial problem during the next seven years, 1983–89. It should not be surprising, therefore, that the Commission was unable to acknowledge the existence of major financial and structural problems that may not become critical for another 10 years.

I urgently suggest that the Senate Finance Committee obtain from the Social Security Administration and the Health Care Financing Administration the most recent projections of income and outgo under the OASDI and HI and SMI portions of Social Security. These projections should be made under the same range of assumptions, from optimistic to pessimistic, that the Board of Trustees used in its annual reports. The projections should extend over the next 75 years—that is, for the remaining lifetime of today's youngsters to whom we are promising benefits. Finally, the projections should be reported on a year-by-year basis and not just as a 75-year average; otherwise the high future costs will be obscured.[4] An impartial examination of these projections of income and outgo would clearly demonstrate the enormity of the system's long-range financial problems. It would also reveal the fact that we have promised more in benefits than the taxpayers will be willing and able to finance, and that we must begin *now*, not later, to redesign Social Security.

The graph (on p. 409) shows projections for the OASDI, HI, and SMI programs combined, based upon the assumptions used in the 1979 Trustees Reports. The projected costs would probably be even higher, based on assumptions currently being used by the Trustees. Adoption of the Commission's recommendations would not decrease these costs significantly, since they would reduce the average 75-year net expenditures by only 1.24 percent of taxable payroll.

Appropriateness of Recommendations

It is tempting to criticize the Commission for not recommending the "correct solution" to Social Security's problems; however, there

[4]For a more detailed rationale for long-range cost estimates, see A. Haeworth Robertson, *The Coming Revolution in Social Security* (McLean, Va.: Security Press, 1981), chap. 10.

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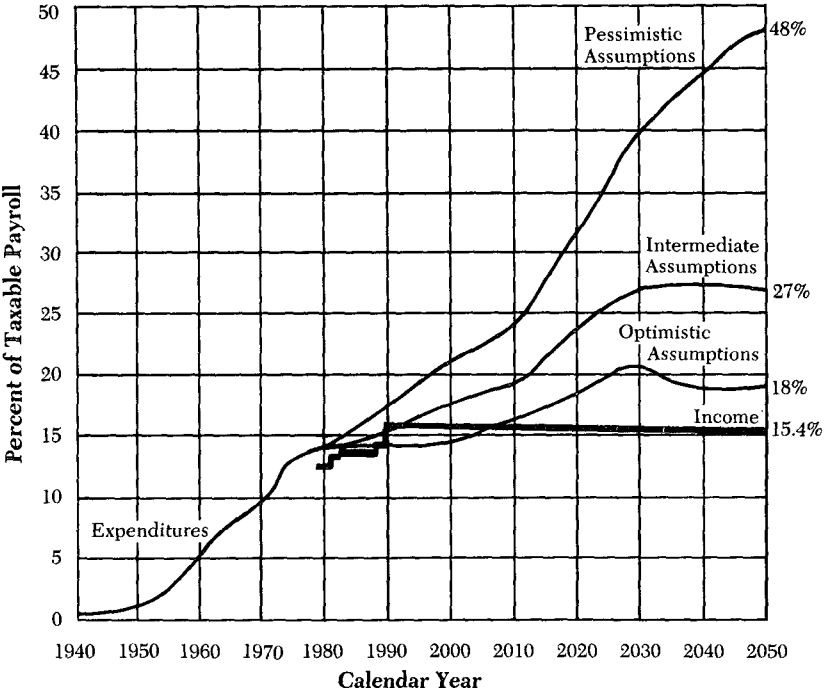
PROJECTED EXPENDITURES AND LEGISLATED INCOME UNDER SOCIAL SECURITY
(as a percentage of taxable payroll)



Source: This chart is derived from data contained in A. Haeworth Robertson, *The Coming Revolution in Social Security* (McLean, Va.: Security Press, 1981), chap. 7.

Note: Projected combined expenditures for OASDI, HI, and SMI (under alternative demographic and economic assumptions) and legislated income are expressed as a percentage of effective taxable payroll.

is no such correct solution. The "proper design" for Social Security depends upon one's values and beliefs about social ethics. Unanimity among diverse interest groups should not be expected. Nevertheless, the following limited commentary may be of value in assessing the recommendations offered by the Commission.

For 47 years the public has thought Social Security's benefits were inviolable. People believed that if the government promised a certain type and level of benefit, it would be paid. People were told that by paying "contributions" to Social Security, they were acquiring "earned rights" to certain benefits. In fact, there has been a steady expansion of benefits and people have generally received even more than prom-

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ised. As recently as December 7, 1979, the Advisory Council on Social Security had the temerity to declare: "After reviewing the evidence, the Council is unanimously convinced that all current and future Social Security beneficiaries can count on receiving all benefits to which they are entitled."[5]

It should be evident that it is no longer true that benefits once promised will certainly be paid. Witness the cuts in student benefits and mimimum benefits that occurred in 1981. Witness the Commission's recommendation to defer the cost-of-living adjustment for six months, and the recommendation to decrease benefits now being paid to people with income (excluding Social Security) of $20,000 or more for a single taxpayer, or of $25,000 or more for joint-return taxpayers. (This reduction in benefits would be accomplished indirectly by taxing half of their Social Security benefits.)[6]

One disturbing aspect of this selective reduction of benefits by taxing them is the implication that if a person saves successfully for his own retirement, he will be rewarded by a reduction in benefits that he presumably counted upon in making his retirement plans. If this means-test philosophy is carried to its logical conclusion, the government will effectively discourage private saving and individual self-reliance, and may even discourage the disclosure of other income. Such a government-induced change in citizen's behavior would be extremely damaging to the character of our nation.

Furthermore, by reneging on its promised benefits, the government will have damaged its image and that of Social Security. This loss of credibility will make it difficult to convince younger taxpayers that Social Security will honor its promise to pay benefits to them some 30 to 50 years hence. Without such a conviction, taxpayers will be very reluctant to pay the high taxes necessary to support the system in the years ahead.

Higher Retirement Ages

The Commission's recommendations make no mention of the inevitable increase in normal retirement age (from age 65 to at least age 70) for persons now less than about age 35 or 40. This will be absolutely necessary to provide the nation with an appropriate-sized work

[5]U.S., Social Security Administration, Department of Health, Education, and Welfare, Advisory Council on Social Security, *Social Security Financing and Benefits: Reports of the 1979 Advisory Council on Social Security* (Washington, D.C.: Government Printing Office, 1979), p. 18.

[6]At the outset, this effective reduction of benefits would apply to only about 10 percent of the OASDI beneficiaries. But since the reduction is not indexed, inflation would eventually cause it to apply to virtually all beneficiaries.

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force, not just to resolve Social Security's financial problems. When today's youngsters retire at age 70 in the next century, they will have more years left to live than their forefathers who retired in the past at age 65. A higher retirement age is *not* a benefit cut; it is a natural consequence of increasing life-spans and improved health. The only tenable way that today's youngsters would be able to retire in their early sixties would be if they had the same short life-spans as their forebears—not a very attractive alternative.

The Commission not only failed to propose higher retirement ages, it indicated that for people to defer their retirement beyond age 65 would not provide any substantial relief to Social Security. This conclusion stemmed from the Commission's proposal to increase the delayed retirement credit for individuals between ages 65 and 70 from 3 percent to 8 percent per year. This is an unrealistic proposal. It is directly contrary to the need for increasing the retirement age and decreasing retirement benefits for future retirees.

Increased Taxes

The Commission's proposals to increase the Social Security system's net income by $168 billion during the next seven years (1983–89) are made up of both benefit decreases and tax increases, with emphasis on the latter. In the face of an immediate fiscal crisis, this emphasis on tax increases may be preferable to an emphasis on benefit decreases. But the system's current financial problems did not arise overnight. They have been in the making since the mid-1970s. Contingency plans could have been made that would have permitted a more even balance between tax increases and benefit decreases. Parenthetically, we have the same opportunity *now* to make plans for accommodating the impending Medicare deficits and to restructure the OASDI program to reflect demographic shifts, the changing role of women in the work force, and so on. Ten years from now, as we frantically search for solutions to this "surprise crisis," we will decry the lack of time to develop well-designed solutions and will once more resort to hastily designed compromises.

Unfortunately, waiting until the last possible moment to resolve the system's financial problems virtually forced the government to use general revenue—a large part of the Commission's recommended tax increase comes from general revenue, particularly in 1983 and 1984. As nearly everyone knows, the nation's budget has a deficit, and there is no general revenue available to use for Social Security. Relying on general revenue to pay benefits is thus tantamount to borrowing—not a very sound basis on which to operate a social insurance system.

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The extent of the Commission's proposed use of general revenue may not be obvious at first glance, because it is done rather indirectly. General revenue would be used in the following manner. First, the increase in the employee Social Security tax for 1984 (from 6.7 percent to 7.0 percent) would be returned to the employee as a tax credit or cash refund, thus reducing general revenue by the same amount as the tax increase. Second, one-half of the total increased self-employment Social Security tax would be deductible as a business expense, thus reducing general revenue by a substantial portion of the tax increase.[7] And third, the lump-sum reimbursement to the old-age trust funds for military-wage credits would be from general revenue.[8]

A more subtle introduction of general revenue would arise from including newly hired federal employees in Social Security. Including federal employees in Social Security is expected to bring a financial gain to the system. This gain arises because more tax money is paid into the system for federal employees than is paid out in benefits. But the ultimate source of all the taxes paid into the system for federal employees is general revenue. Therefore, including federal employees in Social Security will simply cause a shift from direct payroll-tax financing to indirect general-revenue financing.

Although it is not widely known, general revenue is already used to finance three-fourths of the cost of the SMI portion (Part B) of

[7]Although this procedure places the high-income self-employed in the same after-tax position as the present procedure, it places a much larger tax burden on the lower-income self-employed.

[8]This is the ultimate example of how waiting until the last minute to resolve Social Security's financial problems can evoke desperate, even ludicrous, "solutions" that have no substance whatsoever.

Under Social Security, gratuitous military-service credits are granted in some cases without the recipient's having paid Social Security taxes. To prevent a loss to the trust funds, the current procedure is to use general revenue to reimburse the trust funds for the amount of the benefits arising from these credits at the time the benefit is actually paid. The recommendation of the Commission would change this procedure. It would require general-revenue reimbursement to the trust fund *in advance* of the disbursement of benefits. This advance funding of military credits could then be used to meet the current shortfall in the trust funds and permit the continued payment of benefits to other recipients.

Careful analysis reveals this to be an artful machination of the government to give the public a false sense of security without taking any substantive action. The procedure is to take funds from nonexistent general revenue (i.e., raise the national debt by borrowing from the taxpayers), and to pay amounts to Social Security that are not due for many years to come, so that those funds can be used to pay current beneficiaries. The net result is an increase of $20 billion in the national debt in 1983 so that $20 billion can be added to the Social Security trust funds to stave off insolvency for a few more months.

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equivalent of about 1 percent of taxable payroll. With the total cost of SMI projected to rise to 5 percent of payroll, this means that eventually general-revenue financing will amount to nearly 4 percent of payroll. This is twice what the entire Social Security program cost (a combined employer-employee tax of 2 percent) when it was originally adopted.

Universal Mandatory Coverage

As desirable as universal mandatory participation in Social Security might be from several viewpoints, it seems grossly unfair to ban withdrawal from the system by state and local government employers. These employers (and their employees) voluntarily joined Social Security with the understanding that they could withdraw in the future. A unilateral change in this participation agreement seems highly undesirable, if not illegal. State and local governments should at least have a grace period in which to make a final irrevocable decision as to whether they want to withdraw from Social Security or continue to participate.

Mandatory coverage of newly hired federal employes may be desirable in some respects, but it is doubtful that it will save the nation any money—although some advocates of mandatory coverage suggest it will. It is likely that new hires would receive the same total benefits from Social Security and a revised Civil Service retirement system as they now receive from their present system. If so, the total cost of retirement benefits for federal employees would not be reduced; it would simply be rearranged.

Mandatory universal coverage would be defensible if Social Security provided only a minimum floor of protection. It would then be reasonable to impose Social Security's benefits on all employees, including employees of the federal government, nonprofit organizations, and state and local governments. But Social Security is not a minimum floor of protection; it is much more. It provides an array of benefits far beyond those that everyone would agree is a socially desirable minimum. Accordingly, it does not seem reasonable to impose the existing Social Security program on everyone whether they need it or not. If Social Security were reformed to provide a reasonable level and array of benefits that most people could agree was socially desirable, then mandatory universal coverage would be in order.

Problem Is Not Just Financial

In defining the size and scope of the Social Security problem, the Commission gave practically no attention to the strong likelihood

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that the long-range problem is primarily a *design* problem and not just a financial problem. The social and economic environment will be considerably different 30 to 50 years from now, when the children of the post-World War II baby boom approach retirement. The role of women in society and the workplace has changed and will continue to evolve. It is entirely reasonable, therefore, to give serious consideration to a completely new type of social insurance system for the younger segment of our population, even if we continue the present system for the older segment of the population.

What did the Commission have to say on this subject? During the final days of its meetings, the Commission acknowledged that it was committed to the basic structure of the existing Social Security system and contemplated no recommendations for major change. Several members of the Commission noted that the social and economic environment had changed more rapidly than Social Security had changed and that a reexamination of the basic structure of Social Security was therefore in order. They stated, however, that the pressures imposed by the size of the financial problems had diverted their attention from such a comprehensive study. This statement seems absurd for two reasons.

First, the Commission was appointed in December 1981, when the financial problems were well known and well documented, so the Commission had more than adequate time for a thorough study. Second, the inappropriate design of Social Security is a significant factor both in causing the long-range financial problems and in causing doubt about the fairness and thus the long-term viability of the system.

Approximately 80 percent of the nonretired population is younger than 45. It is this large group that is questioning whether Social Security will still be around when it retires. Social Security's future existence depends precisely upon whether or not today's youth will support it, and this depends in turn upon whether it suits their needs and whether they believe it is fair.

Restoration of Public Confidence

The Commission attempted to design recommendations for change in Social Security that would simultaneously resolve the system's financial problems and restore the public's confidence in the long-range viability of the system. This effort to restore public confidence is of paramount importance in view of findings by respected polls that there is now little confidence, especially among young people,[9]

[9]Louis Harris and Associates, Inc., *1979 Study of American Attitudes toward Pensions and Retirement* (New York: Johnson and Higgins, 1979), p. 94.

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that the program will continue to operate in the long-range future. Confidence in the continuation of Social Security is essential, of course, if the taxpayers are to keep supporting the system.

Although much of the Commission's work may be commendable in view of the circumstances, adopting the Commission's recommendations will clearly not resolve very many of Social Security's financial problems. *If the public is misled into believing that the financial problems of Social Security have been resolved, there will be a very harsh day of reckoning in the not-too-distant future.* If public confidence in Social Security and in the government itself erodes any further, the stability of the nation will be in danger.

If Congress does not do a better job than the Commission has of recognizing Social Security's significant future financial problems, it may soon be too late to develop rational solutions, since an atmosphere of crisis seldom yields satisfactory results—as shown by the present situation. If Congress tries to solve the future financial problems without resolving the future *design* problems and thus without gaining greater public support, its efforts will be in vain. Much bolder action will be required by Congress than was recommended by the Commission if Social Security's problems are truly to be resolved. And nothing short of bold action will restore the public's steadily eroding confidence.

Conclusion

If Congress adopts the Commission's meager recommendations for Social Security reform[10] and then assures the public that all is well, the following scenario seems probable.

- In the mid-1980s, the near-term financial problems of Medicare will become as evident as the near-term OASDI problems are now. But Medicare's financial problems are considerably greater than the financial problems of OASDI.
- The short-range Medicare problems will be studied for several years and finally "resolved" at the last possible minute—in about

[10]The substance of the National Commission's recommendations was included in the Social Security Amendments of 1983 (P.L. 98-21), which were enacted on April 20, 1983. In addition, the amendments increased the retirement age by two years (from 65 to 67) for persons reaching age 62 in 2022 and later. For persons reaching age 62 between 2000 and 2021 inclusive, the retirement age was increased by varying amounts of somewhat less than two years. For persons reaching age 62 before 2000 (that is, persons aged 46 and over in 1983), the normal retirement age of 65 was retained. For the exact details of the amendments, the reader should refer to the final legislation and not to the Commission's recommendations.—ED.

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1987. The public will again be assured that all is well with Social Security.

- Simultaneously, in the late 1980s, discontent with the relentlessly increasing taxes will be aggravated by the inappropriate design of Social Security. The social and economic environment will continue to change faster than Social Security is changed. By then people will understand fully that they are not buying and paying for their own benefits and that Social Security is a huge income-transfer program, and they will be extremely restive.
- In the late 1980s or early 1990s, the long-range financial problems of both OASDI and Medicare will start becoming more believable as they become more imminent. It will be clear that people will have to remain in the work force beyond their early sixties, probably until age 70 or so. The first children of the post-World War II baby boom will be approaching age 50, and they will not take kindly to a suggestion that they work another five years or so beyond their planned retirement at age 65. "Why didn't you tell me sooner?" they will ask.

It is difficult to foresee how all of this will end, but one thing is certain: The strife and turmoil in the late 1980s and early 1990s will make today's problems with Social Security look like an afternoon picnic. Fortunately, there is still time to forestall much of this discord. All we need to do is pay more serious attention to the obvious problems that lie ahead and stop kidding ourselves. Realism may be painful, but it is not nearly as fatal as unjustified optimism.

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INDIVIDUAL GAINS AND LOSSES FROM SOCIAL SECURITY BEFORE AND AFTER THE 1983 AMENDMENTS

Anthony Pellechio and Gordon Goodfellow

I. Introduction

Social Security is the major source of income support for retirement in the United States; the Old-Age, Survivors, and Disability Insurance programs (OASDI) will pay benefits of approximately $170 billion in 1983.[1] For many people, Social Security is the main source of retirement income. Exactly what an individual can expect to receive from Social Security is an important question on most people's minds. The purpose of this paper is to answer this question. Standard actuarial methods make it possible to calculate what Social Security benefits will be for a person of any age. This article will present calculations for individuals at different ages and at different levels of earnings in 1983. The individual cases examined here make it possible for readers to see how Social Security works and to obtain an idea of their own treatment under the system.

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The authors are employed in the Office of Income Security Policy as deputy assistant secretary and senior policy analyst, respectively, at the Department of Health and Human Services, Washington, D.C. 20201.

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A detailed explanation of the methodology of this paper, the "prototype model" used to compute benefits and taxes, and the basic data set are available from the authors upon request.

[1] *1983 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, D.C.: Social Security Administration, 1983).

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What an individual can expect to receive from Social Security is an especially interesting question this year because of the major Social Security legislation (Public Law 98-21) enacted on April 20, 1983. (This legislation will be alternately referred to as the 1983 Social Security Amendments or the new legislation.) Much of the discussion of Social Security's financial problems and proposed solutions before the 1983 Social Security Amendments was in aggregate dollar terms. This paper includes calculations of individual treatment under Social Security both before and after the new legislation and illustrates the effects of this legislation on different individuals in dollar terms.

The concept of what an individual can expect to receive from Social Security is an important one. The Social Security benefits that an individual can expect to receive have a dollar value and, as such, represent a form of wealth. More precisely, Social Security wealth is the actuarial present value of the Social Security benefits to which an individual is entitled as a retired or disabled worker. *Actuarial* means that the likelihood of surviving to retirement years or becoming disabled is taken into account. *Present value* refers to the conversion of future income, in this case future Social Security benefit payments, into current dollar values; the way this conversion is done is described in section II. Thus, Social Security wealth is the total amount that an individual can expect to receive in Social Security benefits, expressed in today's dollars. This paper presents the value of Social Security wealth for both single and married individuals, by age and earning levels.

To receive benefits, an individual must pay payroll taxes into the Social Security system. However, there is no direct link between the taxes an individual pays and the benefits he receives. Like benefits, payroll taxes have a total dollar value—expressed by the actuarial present value of the payroll taxes a worker pays during his working life. "Actuarial" and "present value" mean what they did for Social Security wealth—with two slight modifications. One modification is that "actuarial" refers to the fact that surviving to work or becoming disabled in the years before retirement is taken into account. The other modification is that past payroll taxes are brought up to their value in today's dollars by adding the interest that would accumulate from these taxes between the year they were paid and the present. The interest rate at which past taxes are brought forward is described in section II. The present value of payroll taxes ("actuarial" will be dropped for the sake of convenience and assumed in "present value") is the amount that an individual pays into the system in actual dollars, plus forgone interest.

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The difference between Social Security wealth and the present value of payroll taxes gives the total gain or loss from Social Security over an individual's lifetime. This difference can be interpreted as the amount of money that Social Security would be giving or taking away today if it were done all at once rather than spread over a lifetime.

The value of Social Security wealth, the present value of payroll taxes, and the resulting net gain and loss for individual cases are presented both before and after the 1983 Social Security Amendments in sections III and IV respectively. The calculations are the product of a computer-simulation model developed by the authors. The model is flexible in a number of important ways. The base year that defines present value can be freely set; in this paper it is 1983. The model is flexible with respect to the ages, earning levels, and family situations that define individual cases. The particular ages and smooth earnings patterns used below were chosen to cover a wide range of individual cases, but the simulation model is in no way restricted to these examples. It should be obvious from an examination of the calculations before and after the 1983 Social Security Amendments that the model can be used to examine changes in the Social Security system. The model has been called the "prototype model" because of its ability to examine prototypical individual cases.

An explanation of how the Social Security system works and how future benefits and taxes are converted into current dollar values is discussed in the next section. The section will help clarify the calculation of Social Security benefits, Social Security wealth, and the present value of payroll taxes.

II. Explanation of Social Security Calculations

Social Security benefits are based on an individual's earnings in employment that is covered by the system during his working life.[2] The system counts earnings up to a maximum amount of $35,700 this year (1983). Above this amount, earnings are not taxed or counted in the benefit formula. The maximum earnings levels used in the tax and benefit calculations for past years are given in column 2 of table 1. The combined employer and employee payroll-tax rates for past years are given in column 3.

The benefit calculation begins by computing an individual's average annual covered earnings. Past earnings are first converted to their

[2]For a more detailed discussion of the Social Security benefit calculation, see National Commission on Social Security Reform, "Basic Method of Computing Social Security Benefits," memorandum no. 1, March 9, 1982.

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TABLE 1

MAXIMUM TAXABLE EARNINGS UNDER SOCIAL SECURITY, PAYROLL-TAX RATES, INTEREST RATES, AND PROPORTIONAL WAGE INCREASES IN PAST YEARS

Year	Maximum Taxable Earnings	Combined Payroll-Tax Rate	Interest Rate	Proportional Wage Increase
1937	$3,000	2.000%	2.25%	14.173
1938	3,000	2.000	2.25	15.486
1939	3,000	2.000	2.25	14.545
1940	3,000	2.000	2.25	13.752
1941	3,000	2.000	2.25	12.501
1942	3,000	2.000	2.25	11.056
1943	3,000	2.000	2.25	9.491
1944	3,000	2.000	2.25	8.765
1945	3,000	2.000	2.25	8.993
1946	3,000	2.000	2.25	8.544
1947	3,000	2.000	2.25	7.342
1948	3,000	2.000	2.25	6.649
1949	3,000	2.000	2.25	6.493
1950	3,000	3.000	2.25	6.102
1951	3,600	3.000	2.36	5.416
1952	3,600	3.000	2.46	5.099
1953	3,600	3.000	2.85	4.829
1954	3,600	4.000	2.40	4.804
1955	4,200	4.000	2.82	4.592
1956*	4,200	4.000	3.18	4.292
1957	4,200	4.500	3.65	4.163

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1958	$4,200	4.500%	3.32%	4.127
1959	4,800	5.000	4.33	3.932
1960	4,800	6.000	4.12	3.783
1961	4,800	6.000	3.88	3.710
1962	4,800	6.250	3.95	3.533
1963	4,800	7.250	4.00	3.448
1964	4,800	7.250	4.19	3.313
1965	4,800	7.250	4.28	3.254
1966	6,600	7.700	4.92	3.070
1967	6,600	7.800	5.07	2.908
1968	7,800	7.600	5.65	2.721
1969	7,800	8.400	6.67	2.572
1970	7,800	8.400	7.35	2.451
1971	7,800	9.200	6.16	2.333
1972	9,000	9.200	6.21	2.125
1973	10,800	9.700	6.84	2.000
1974	13,200	9.900	7.56	1.888
1975	14,100	9.900	7.99	1.756
1976	15,300	9.900	7.61	1.643
1977	16,500	9.900	7.42	1.550
1978	17,700	10.100	8.41	1.436
1979	22,900	10.160	9.44	1.321
1980	25,900	10.160	11.46	1.212
1981	29,700	10.700	13.91	1.101
1982	32,400	10.800	13.00	1.046
1983	35,700	10.800	11.40	1.000

*The Disability Insurance (DI) program was begun in 1956, and a portion of the payroll-tax rate was added and earmarked for the DI program.

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value in current dollars. This is done by taking earnings in a particular year and increasing them by the same proportion that average covered wages increased in the population as a whole since that year. The proportional increases in wages from past years are given in column 5 of table 1. Using these proportions, past covered earnings can be updated to their value in terms of current covered wages. For example, using the value of 2.451 for 1970, earnings of $10,000 in 1970 would be updated to a value of $24,510 in 1983. Earnings updated in this way are said to be *wage-indexed.* The average of wage-indexed annual earnings, after excluding the five years of lowest earnings, is used as the base for calculating benefits. This average annual amount is divided by 12 to put it in monthly terms; it is called the *average indexed monthly earnings* and is abbreviated AIME. In the technical language of the Social Security system, AIME is an individual's benefit base.

A person's basic benefit (i.e., the benefit amount received by an individual without dependents) is called the primary insurance amount and is abbreviated PIA. The formula in 1983 for calculating the basic monthly benefit (PIA) from the benefit base (AIME) is:

90 percent of the first $254 of AIME, plus
32 percent of AIME over $254 through $1,528, plus
15 percent of AIME over $1,528.

The percentage rates (90, 32, and 15 percent) are referred to as the *bracket replacement rates* or simply called the *bracket rates.* The AIME amounts related to the brackets ($254 and $1,528) are called the *bend points* of the formula. The formula is explicitly tilted toward those with lower lifetime earnings, replacing a higher proportion of low earnings (90 percent) than of high earnings (15 percent).

Two basic objectives are incorporated in the Social Security formula. The first objective is to reallocate an individual's lifetime income from working years to retirement years to provide support for his own retirement. Computing benefits from an average of a worker's earnings reflects this objective. The present value of payroll taxes represents a measure of the reallocation of individual lifetime income achieved through the system. This reallocation will be referred to as the *individual equity* in the system. The second objective is to redistribute lifetime income between individuals to provide adequate retirement support and achieve other social-insurance objectives. The tilt in the Social Security benefit formula and the payment of dependents and survivors benefits reflect the explicit intent of the system to allocate benefits partly on the basis of need. A measure of the redistributive elements of the system is reflected by the difference between the present value of payroll taxes and Social Security

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wealth. The redistributive elements of Social Security will be referred to as the *social adequacy* of the system.

Current law requires that the bend points in the PIA formula be increased by the same proportion that average wages grow in the economy. Thus, the bend points are wage-indexed, as are earnings in the calculation of AIME. Because the law specifies the benefit formula into the indefinite future, the benefit for a person of any age can be computed as long as a rate of growth of earnings is known.

Whether an individual pays only the employee portion of the payroll tax or pays the combined employer and employee portions is an important issue in the calculation of the present value of payroll taxes. This question was addressed by Robert J. Myers in his presentation of similar calculations to the National Commission on Social Security Reform:

> A major element in the analysis is whether only the employee tax rate should be considered, or whether the combined employer-employee tax should be the basis for comparison. Many individuals believe that the latter basis is the appropriate one, because many economists view that the employer tax is borne entirely by the employee through lower wages than would otherwise be paid. Others believe, however, that—at least, in part—the employer tax is passed on to consumers in general (who, in the aggregate, largely consists of employees and their families) in the form of higher prices; under these circumstances, it is not possible to state that each employee fully bears, in an indirect manner, the employer taxes on his or her wages, but rather it could be more or less so.[3]

The calculations presented to the National Commission on Social Security Reform included both the employer and employee portions of the payroll tax in the calculation of the present value of individual payroll taxes. We have adopted this approach for our calculations.

The present value of payroll taxes is calculated by adding to taxes the interest that would have accumulated from the year they were paid. An appropriate interest rate for this calculation is the rate at which funds can be safely invested. The exact specification of such an interest rate is not clear cut. We used the approach followed by the National Commission on Social Security Reform. This approach uses the yearly average interest rate on new special-issue investments of the Social Security trust funds for 1951 through 1982 and an assumed 2.25-percent rate for 1937 through 1950. These rates are shown in column 4 of table 1.

[3]National Commission on Social Security Reform, "Money's-Worth Comparison for Social Security Benefits," memorandum no. 45, August 12, 1982.

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For the individual cases examined here, benefits are based in part on earnings in the future. This involves projecting an individual's future earnings. Our approach uses projections for wages and prices from the *1983 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (hereafter referred to as the *1983 Trustees Report*). This report, required by law, provides an annual statement of the income and disbursements of the Social Security system. It includes projections of future income and disbursements under four sets of economic assumptions. The assumptions range from "optimistic" (Alternative I), to "intermediate" (Alternatives II-A and II-B), to "pessimistic" (Alternative III). The intermediate II-B assumptions are considered to be the most realistic of the four sets of assumptions and are used in our calculations.[4] The projected inflation rate and rate of growth of real earnings in future years under Alternative II-B are given in columns 2 and 3 of table 2. Although we chose to use projections from the *Trustees Report* because the National Commission on Social Security Reform used them, it is worth noting that our computer-simulation model (the prototype model) is not restricted to this set of projections.

In our calculation of Social Security wealth, the benefit amounts that individuals can expect to receive in future years are converted to their value in 1983 dollars. The present value of a benefit payment in a future year is defined as the amount that would have to be invested today to yield that future payment. To calculate this amount, interest rates in future years have to be specified. Rates included in the *1983 Trustees Report* were used. Projected future interest rates under Alternative II-B are given in column 4 of table 2. Based on these rates, a benefit payment of $10,000 in the year 2003 has a present value of $2,992. In other words, $2,992 would have to be invested in 1983 to yield a one-time payment of $10,000 in 20 years, at the interest rates in table 2.

The calculation of the present value of future benefit payments does not depend as much on the actual level of the interest rate as it does on the difference between the interest rate and the inflation rate. The "real" interest rate is the important factor in calculating the

[4]The effect of using economic assumptions that differ from Alternative II-B can be examined with our prototype model. For example, if price inflation is assumed to be greater relative to real wage growth, individual returns from Social Security would decline. The prototype model also allows us to depart from the assumption that rates of growth are constant after 1995 (see table 2) and incorporate business cycles in the economic forecast instead. The effect of business cycles on the calculations depends on the pattern of projected cycles and cannot be easily summarized.

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TABLE 2

PROJECTED FUTURE INFLATION RATES, REAL EARNINGS GROWTH RATES, INTEREST RATES, AND PAYROLL-TAX RATES

Year	Inflation Rate	Real Earnings Growth Rate	Interest Rate	Old Law: Payroll-Tax Rate	Current Law: Payroll-Tax Rate
1983	3.1	1.5	11.4	10.80	10.80
1984	4.4	.2	9.3	10.80	11.40
1985	5.3	.2	8.0	11.40	11.40
1986	4.8	.8	7.1	11.40	11.40
1987	4.4	1.3	6.8	11.40	11.40
1988	4.1	1.3	6.6	11.40	12.12
1989	4.0	1.4	6.5	11.40	12.12
1990	4.0	1.6	6.4	12.40	12.40
1991	4.0	1.7	6.4	12.40	12.40
1992	4.0	1.6	6.3	12.40	12.40
1993	4.0	1.5	6.2	12.40	12.40
1994	4.0	1.5	6.2	12.40	12.40
1995	4.0	1.5	6.1	12.40	12.40
1996	4.0	1.5	6.1	12.40	12.40
1997	4.0	1.5	6.1	12.40	12.40
1998	4.0	1.5	6.1	12.40	12.40
1999	4.0	1.5	6.1	12.40	12.40
2000*	4.0	1.5	6.1	12.40	12.40

*Growth rates and payroll-tax rates remain at their year-2000 levels in subsequent years.

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present value of benefits. This can best be illustrated with an example. Consider an individual age 25 in 1983 whose earnings in 1983 were $20,000 and whose future earnings are expected to grow according to the rates of inflation and real earnings growth projected in the *Trustees Report*. This individual's benefit in 2023, the year he turns age 65, would be $60,288. The present value of the benefit, computed using the interest rates in table 2, is $5,359. Recomputing this example at inflation rates and interest rates that are three percentage points higher than in table 2 yields a benefit level in 2023 that has a present value of $5,229. At inflation rates and interest rates that are three percentage points lower than in table 2, the benefit has a present value of $5,385. This example illustrates that the inflation and interest rates affect the calculation of present values very little, as long as the difference between the two rates remains about the same.

In summarizing, we have calculated benefits and payroll taxes for individual cases according to the law in 1983, both before and after the 1983 Social Security Amendments. Past payroll taxes are converted into 1983 dollars by adding the amount of interest that would accrue on these taxes between the time they were paid and the present. The rates of inflation and real earnings growth used in the *1983 Trustees Report* are used to project future earnings. Because Social Security law specifies how the system is to work into the indefinite future, an individual's future payroll taxes and benefits can be computed. Future payroll taxes and benefits are converted into dollars of present value for 1983 using the interest rates projected in the *1983 Trustees Report*. This information allows us to calculate an individual's expected Social Security benefits and taxes in terms of today's dollars.

III. Individual Gains and Losses before the 1983 Social Security Amendments

The concepts of Social Security wealth and the present value of payroll taxes have been introduced in section I and were described in more detail in section II. This section is devoted to a presentation of these calculations under the law before the 1983 Social Security Amendments. Table 3 presents calculations for individuals in the following family situations: a one-earner married couple in which either the husband works or the wife works; a two-earner married couple in which both husband and wife earn an equal amount; and a single individual, who may be either male or female. The age of the earners in each of these family situations is set at 40 years (calculations at ages 25 and 55 are presented later). All family types have

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TABLE 3

GAINS AND LOSSES FOR INDIVIDUALS AGE 40 UNDER OLD LAW
(Expressed in Present-Value Dollars in 1983)[a]

Total Earnings in 1983[b]	Family Situation				
	Husband Works	Wife Works	Both Spouses Work	Unmarried Male	Unmarried Female
$10,000					
SSW	77,656	81,059	62,381	37,508	52,549
PVTAX	42,858	43,909	43,384	42,858	43,909
Gain/Loss	34,798	37,150	18,997	−5,350	8,640
$15,000					
SSW	101,889	106,363	76,558	49,220	68,961
PVTAX	64,287	65,864	65,075	64,287	65,864
Gain/Loss	37,602	40,500	11,482	−15,068	3,097
$20,000					
SSW	125,967	131,506	90,745	60,855	85,265
PVTAX	84,919	87,021	86,767	84,919	87,021
Gain/Loss	41,048	44,485	3,978	−24,064	−1,755
$25,000					
SSW	136,783	142,889	104,917	66,135	92,700
PVTAX	102,169	104,797	108,459	102,169	104,797
Gain/Loss	34,614	38,092	−3,542	−36,034	−12,097
$30,000					
SSW	145,586	152,279	119,084	70,510	98,912
PVTAX	116,279	119,431	130,151	116,279	119,431
Gain/Loss	29,308	32,848	−11,067	−45,769	−20,520
$35,700					
SSW	154,075	161,379	135,240	74,752	104,954
PVTAX	129,777	133,491	154,512	129,777	133,491
Gain/Loss	24,298	27,888	−19,269	−55,025	−28,537

[a]Some of the gain/loss calculations are off by one unit due to rounding.
[b]SSW = Social Security wealth; PVTAX = present value of payroll taxes; Gain/Loss = net gain or loss.

the same total 1983 earnings given in the indicated rows of the table. Table 3 provides a clear picture of the redistribution of lifetime income in today's dollars between individuals and married couples at different earnings levels.

To see the implications of the tilt in the Social Security benefit formula on a lifetime basis, consider the results for single individuals. The table shows a sharp decline in net gains from Social Security as

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earnings increase. Single men incur losses at all earnings levels—losses that rise as earnings increase. At the $10,000 earnings level, Social Security wealth for a 40-year-old single male is $37,508, and the present value of the payroll taxes paid over his working life is $42,858, yielding a net loss in lifetime income of $5,350. The same male at the maximum taxable earnings level of $35,700 has Social Security wealth of $74,752 and a present value of payroll taxes of $129,777, yielding a loss in lifetime income of $55,025. For a 40-year-old single woman there is a gain in lifetime income of $8,640 at the $10,000 earnings level and a loss of $28,537 in lifetime income at the maximum taxable earnings level. The redistribution of lifetime income between individuals in the same family situation but at different earnings levels provides a lifetime perspective on the effect of the tilt in the benefit formula.

Table 3 also shows that women fare much better than men in their lifetime treatment under Social Security. At the $20,000 earnings level, a 40-year-old single male can expect to lose $24,064 in lifetime income, while a 40-year-old single female can expect to lose only $1,755 (with a Social Security wealth of $85,265 she is essentially breaking even).

The reason for this disparity between men and women is that women have higher survival rates than men. The survival rate for reaching age 65 for 40-year-old women is 86 percent, compared to 74 percent for 40-year-old men. On average, women can also expect to collect benefits about 4.5 years longer than men. Differences in survival rates are also responsible for the higher present value of payroll taxes for women than men at the same earnings levels (i.e., women have a higher chance of surviving to pay payroll taxes in the future). In general, identified groups of workers that live longer obtain higher gains in lifetime income from Social Security.

Table 3 illustrates the variation in expected benefits between single individuals and one-earner couples. Although a single man earning $20,000 at age 40 pays exactly the same taxes as a one-earner couple (when the husband works), he receives $65,112 less in total benefits—the equivalent of over 3.25 years of work. Because of differences in survival rates, single women fare somewhat better in relation to one-earner couples than single men do. Single women age 40 earning $20,000 receive $46,241 less in total Social Security benefits than a one-earner couple in which the wife works, which amounts to approximately 2.25 years of earnings.

One-earner couples also fare well in relation to two-earner couples. A one-earner couple in which the husband (age 40) earns $20,000 can currently expect a gain of $41,408 from Social Security, which is

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$37,070 more than the gain for a two-earner couple (both age 40) in which each spouse earns $10,000. By any reasonable standard, the $20,000 one-earner couple is richer than the $20,000 two-earner couple, since the nonworking spouse in the one-earner couple could also work and earn income. Presumably the nonworking spouse provides household services that exceed in value the compensation from market work. Yet, in the above example, the current system provides the one-earner couple with $37,070 extra. This is equivalent to approximately two years of earnings. In other words, the current structure of Social Security requires the less-well-off two-earner couple to work an additional two years to end up with the same lifetime income that the one-earner couple receives.

It is also possible for two families to pay in different amounts and receive identical benefits. This is a consequence of the way the system awards benefits to dependents and survivors. Whether a wife works or not, as a dependent spouse she is entitled to receive a benefit based on half of her husband's own basic benefit, i.e., half of his PIA. Consequently, if her earnings entitled her to a benefit that is less than half of her husband's, she is entitled to no more than if she had not worked at all. If her benefit is more than half of her husband's, she gains only the difference between her benefit and half of his. Even if this is the case, she will switch to receiving her husband's benefit in the event of his death because as a surviving spouse she is entitled, whether she works or not, to her husband's full benefit. Thus, under Social Security, working does not entitle a wife whose earnings are less than her husband's to much more than if she never worked. The same holds true for a husband whose earnings are less than his wife's.

Benefits to dependents and survivor spouses are only part of an array of so-called ancillary benefits awarded by Social Security. These ancillary benefits are "add-ons" to a worker's own benefit (i.e., his PIA) and represent a departure from tying his benefits to the contributions he made into the system. The point here is not to suggest the elimination of such benefits. These benefits reflect a fundamental conflict between having benefits depend strictly on the degree to which a worker supported the system through payroll taxes (individual equity) and providing insurance to his family (social adequacy).

The calculations in table 3 for 40-year-olds were also done for 25- and 55-year-olds. The results are presented in tables 4 and 5. The pattern of redistribution shown for 40-year-olds (between individuals at different earnings levels, men and women, single individuals and married couples, and one-earner and two-earner couples) is repeated with these age groups. The tables present basically the same pattern

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TABLE 4

GAINS AND LOSSES FOR INDIVIDUALS AGE 25 UNDER OLD LAW
(Expressed in Present-Value Dollars in 1983)[a]

Total Earnings in 1983[b]	Family Situation: Husband Works	Wife Works	Both Spouses Work	Unmarried Male	Unmarried Female
$10,000					
SSW	72,370	77,270	61,126	33,890	49,782
PVTAX	40,077	41,536	40,807	40,077	41,536
Gain/Loss	32,293	35,734	20,319	−6,187	8,246
$15,000					
SSW	94,956	101,392	75,009	44,475	65,331
PVTAX	60,116	62,304	61,210	60,116	62,304
Gain/Loss	34,840	39,088	13,799	−15,641	3,026
$20,000					
SSW	117,328	125,341	88,895	54,985	80,773
PVTAX	80,154	83,073	81,613	80,154	83,073
Gain/Loss	37,174	42,268	7,281	−25,169	−2,299
$25,000					
SSW	128,107	136,808	102,780	59,996	88,129
PVTAX	100,193	103,841	102,017	100,193	103,841
Gain/Loss	27,915	32,967	763	−40,197	−15,712
$30,000					
SSW	138,693	148,113	116,655	64,956	95,416
PVTAX	120,231	124,609	122,420	120,231	124,609
Gain/Loss	18,462	23,504	−5,765	−55,275	−29,193
$35,700					
SSW	149,934	160,170	132,359	70,249	103,204
PVTAX	140,784	145,936	145,680	140,784	145,936
Gain/Loss	9,150	14,234	−13,321	−70,535	−42,732

[a]Some of the gain/loss calculations are off by one unit due to rounding.
[b]SSW = Social Security wealth; PVTAX = present value of payroll taxes; Gain/Loss = net gain or loss.

of gains and losses within particular age groups, i.e., the same pattern of *intra*generational redistribution.

Comparisons among tables 3, 4, and 5 illustrate some important differences in the treatment of different generations by Social Security—the so-called *inter*generational redistribution of the system. Overall, there is redistribution of lifetime income from young to old. This is illustrated for any particular family type. A single male, age

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TABLE 5

GAINS AND LOSSES FOR INDIVIDUALS AGE 55 UNDER OLD LAW
(Expressed in Present-Value Dollars in 1983)[a]

Total Earnings in 1983[b]	Family Situation				
	Husband Works	Wife Works	Both Spouses Work	Unmarried Male	Unmarried Female
$10,000					
SSW	88,168	89,053	69,301	43,063	57,761
PVTAX	37,730	38,164	37,974	37,730	38,164
Gain/Loss	50,438	50,889	31,354	5,334	19,597
$15,000					
SSW	115,711	116,886	85,062	56,525	75,822
PVTAX	56,595	57,245	56,920	56,595	57,245
Gain/Loss	59,117	59,640	28,142	−69	18,577
$20,000					
SSW	140,411	141,966	100,824	68,683	92,178
PVTAX	72,695	73,563	75,893	72,695	73,563
Gain/Loss	67,716	68,403	24,931	−4,013	18,615
$25,000					
SSW	148,828	150,478	116,586	72,798	97,703
PVTAX	83,139	84,223	94,867	83,139	84,223
Gain/Loss	65,689	66,255	21,719	−10,341	13,480
$30,000					
SSW	153,760	155,615	132,347	75,312	101,136
PVTAX	90,441	91,742	113,840	90,441	91,742
Gain/Loss	63,319	63,873	18,507	−15,128	9,394
$35,700					
SSW	158,060	160,135	150,248	77,532	104,181
PVTAX	96,662	98,197	134,268	96,662	98,197
Gain/Loss	61,398	61,937	15,980	−19,130	5,984

[a]Some of the gain/loss calculations are off by one unit due to rounding.
[b]SSW = Social Security wealth; PVTAX = present value of payroll taxes; Gain/Loss = net gain or loss.

25, earning $20,000 in 1983, can expect to lose $25,169. A single male age 40 at the same earnings level faces a loss of $24,064. A 55-year-old single male earning $20,000 can expect a loss of $4,013. If these males married and the wife had no earnings, they would all gain. The gains would be $37,174 at age 25, $41,048 at age 40, and $67,716 at age 55. The pattern of smaller gains or greater losses for younger generations is consistent for all types of families.

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Although the results illustrate different treatment for different generations, they do not mean that as individuals get older their treatment under Social Security improves. A 25-year-old who is losing income today will be losing the same amount in 1983 dollars when he is 40 or 55.

Differences in the treatment of generations by Social Security are consistent with historical development of the system. The growth of the system has been documented and discussed in numerous articles and books on the subject,[5] so the discussion here will be brief. The redistribution of income to the elderly was greatest, in terms of total benefits compared to total taxes, when the system was initiated. Benefits were paid immediately to individuals who did not pay into the system. The economic environment of the 1930s had a great impact on this provision of the program. The Social Security system was conceived and established during the time of the Great Depression. The economic hardships brought upon the elderly who saw their lifetime savings severely reduced and who could not reasonably have prepared for such an event gave impetus to the establishment of a Social Security system that paid benefits immediately. The system represents, in part, a transfer from younger generations to the elderly harmed by the Great Depression—a transfer that conferred large gains in lifetime income on its initial beneficiaries.

The Great Depression imposed economic losses not only on the elderly of the time, but also on nearly the entire working and retired population. Thus, the payment of net gains of lifetime income through Social Security to people reaching retirement as late as 1983 can be justified on the grounds that they also suffered from the Great Depression.

Although the Great Depression had some influence on the initial development of the system, in the 1950s, 1960s, and 1970s the system responded to the economic and political environment of those times.

[5]For example, see Martha Derthick, *Policymaking for Social Security* (Washington, D.C.: Brookings Institution, 1979); Robert J. Myers, *Social Security*, 2d ed. (Homewood, Ill.: Richard D. Irwin, Inc., 1981); Sylvester J. Schieber, *Social Security: Perspectives on Preserving the System* (Washington, D.C.: Employee Benefit Research Institute, 1982).

The effect of Social Security on individual behavior and the economy has been the subject of considerable research. A review of the relationship between Social Security and savings is provided by Mordecai Kurz,"Analyzing Social Security and Intergenerational Capital Formation and Transmission," paper prepared for the Center for Economic Policy Research Conference on Social Security, Stanford University, May 1983. At the same conference, Michael Hurd reviewed the relationship between Social Security and retirement behavior in his paper, "The Effect of Social Security on Retirement: Results and Issues."

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Retirees during these decades were awarded large gains in lifetime income from Social Security because the system and the economy were growing. That growth put surplus revenue into the Social Security trust funds. With those surpluses, it was easy for Congress to increase benefit levels through more generous benefit formulas and more ancillary benefits (i.e., more add-ons based on a worker's family situation).

Today the system has reached maturity—it covers nearly the entire U.S. population. Workers, even those near retirement, have paid into the system during an entire working life. The result of having more years of a person's working life covered by the system at higher payroll-tax rates is that the gains from the system are less for younger generations. Because the system now covers workers' entire careers at substantial rates of payroll taxation, there has been a significant shift in people's view of Social Security. People regard Social Security more as an investment they make over their entire life than as a system of transfers to the elderly, as the system was conceived to be. The question of individual gains and losses addressed by our paper arises naturally from the maturation of the Social Security system.

IV. Individual Gains and Losses under the 1983 Social Security Amendments

The results presented in the previous section attach dollar amounts to Social Security's two basic objectives, individual equity and social adequacy. The results express in dollar terms the distributional choices that underlay the structure of Social Security before the new legislation went into effect. Those figures also provide a backdrop for examining the new legislation. Taken together, the calculations in the last section and those presented in this section provide a quantitative picture of the changes in the distributional composition of Social Security. The calculations quantify the distributional choices made in the construction of this year's legislation.

The new legislation contains many specific provisions, some of which have only minor effects on our calculations. We have focused our analysis on the major provisions that have general applicability. The provisions we have added in this section to the calculations of section III are: (1) the increase in the payroll-tax rate; (2) the six-month delay in the cost-of-living adjustment of benefit payments; (3) the increase in the retirement age; and (4) the taxation of Social Security benefits.

1. Increase Payroll Taxes

Payroll-tax revenue is raised by advancing the payroll-tax increases previously scheduled for 1985 to 1984 and advancing part of the

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scheduled 1990 increase to 1988. The combined tax rates for employers and employees under the previous law and under the new law are:

Year	*Previous Schedule*	*New Schedule*
1984	10.80%	11.40%
1985	11.40	11.40
1986–87	11.40	11.40
1988–89	11.40	12.12
1990 and after	12.40	12.40

As has been the case throughout this paper and its calculations, these payroll-tax rates refer to the OASDI portion of Social Security.

2. *Delay the Cost-of-Living Adjustment (COLA) of Benefit Payments*

The July 1983 COLA scheduled under the old law will be delayed to January 1984, and annual COLAs thereafter will take place each January. The July 1983 COLA would have been 3.6 percent, which is equal to the increase in the Consumer Price Index (CPI) from the first quarter of 1982 to the first quarter of 1983. This 3.6-percent increase will instead be applied to benefit payments in January 1984. The January 1985 COLA will equal the percentage increase in the CPI from the third quarter of 1983 to the third quarter of 1984. Subsequent January COLAs will be similarly based on the previous two third-quarter CPIs.

The six-month COLA delay affects both current and future retirees. Before the new legislation, prospective retirees could expect a COLA in the first year of retirement. This occurred because the July COLA was applied whether an individual retired at the beginning or at the end of the year. For example, consider two individuals who plan to retire at age 65; one was born in January and the other was born in December. The January retiree would start to receive benefits based on his PIA computed in January, and under the old law he would receive a COLA in July. The PIA of the December retiree would be computed in exactly the same way as that of the January retiree; if their AIMEs were the same, their PIAs would be equal. The COLA of the previous July would be applied to the December retiree's PIA, making his benefit payment the same as the January retiree's. In this way all cohorts (i.e., individuals born in the same year and retiring in the same year) were treated the same in terms of the calculation of their monthly benefit amounts, regardless of when in the year their birthdays fell.

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By moving the COLA from July to January, the new legislation makes future retirees wait longer for their first and subsequent COLAs. As a result, a future retiree's benefit payments in any given year will be lower than they would have been under the old law. The total effect of this will be seen in lower values of Social Security wealth.

3. *Raise the Retirement Age*

The retirement age (more precisely, the age at which individuals are eligible for full retirement benefits) is raised from 65 to 67 in two steps: (1) from 65 to 66 by two months per year for people who reach age 62 in the years 2000–2005; (2) from 66 to 67 by two months per year for people reaching age 62 in the years 2017–2022. Reduced benefits remain available at age 62, but the reduction factor is increased from 20 to 25 percent when retirement age is 66 and to 30 percent when retirement age is 67.

4. *Tax Social Security Benefits*

The provision for taxing Social Security benefits begins in 1984. It includes in taxable income up to one-half of Social Security benefits if the taxpayer's income exceeds a threshold of $25,000 for a single taxpayer and $32,000 for married taxpayers. The income associated with these thresholds is adjusted gross income (AGI), plus nontaxable interest income, plus one-half of Social Security benefits. If the taxpayer's income exceeds the threshold, then the amount of Social Security benefits added to taxable income equals the lesser of either (1) one-half of the excess of the taxpayer's income that is over the threshold or (2) one-half of Social Security benefits. This amount multiplied by the taxpayer's marginal tax rate is the additional income-tax revenue that is aggregated to compute the amount of general revenue that will be transferred to the Social Security trust funds.

Taxation of Social Security benefits introduces the estimation of the income of beneficiaries into our calculations. There are various ways to impute income. We chose to assume that retirement income other than Social Security equals 15 percent of earnings in the last year before retirement. This is a conservative assumption, producing a low estimate of the additional income tax an individual will have to pay due to the taxation of Social Security benefits.[6]

Tables 6, 7, and 8 present the calculations of Social Security wealth and present value of payroll taxes after the 1983 amendments for

[6]Using a higher estimate of retirement income as a percentage of preretirement income would increase the additional taxes that individuals pay as a result of the taxation of Social Security benefits.

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TABLE 6

GAINS AND LOSSES FOR INDIVIDUALS AGE 40 UNDER NEW LAW
(Expressed in Present-Value Dollars in 1983)[a]

Total Earnings in 1983[b]	Family Situation				
	Husband Works	Wife Works	Both Spouses Work	Unmarried Male	Unmarried Female
$10,000					
SSW	72,447	75,399	57,633	34,685	48,468
PVTAX	43,042	44,094	43,568	43,042	44,094
Gain/Loss	29,405	31,305	14,065	−8,357	4,374
$15,000					
SSW	95,053	98,936	70,730	45,515	63,605
PVTAX	64,563	66,141	65,352	64,563	66,141
Gain/Loss	30,490	32,794	5,378	−19,048	−2,537
$20,000					
SSW	117,515	122,322	83,837	56,274	78,643
PVTAX	85,286	87,391	87,136	85,286	87,391
Gain/Loss	32,229	34,931	−3,299	−29,912	−8,748
$25,000					
SSW	127,601	132,905	96,929	61,157	85,500
PVTAX	102,629	105,260	108,920	102,629	105,260
Gain/Loss	24,972	27,645	−11,991	−41,472	−19,760
$30,000					
SSW	135,750	141,545	110,016	65,028	91,008
PVTAX	116,830	119,987	130,704	116,830	119,987
Gain/Loss	18,920	21,558	−20,688	−51,802	−28,979
$35,700					
SSW	143,479	149,746	124,943	68,602	96,101
PVTAX	130,430	134,150	155,168	130,430	134,150
Gain/Loss	13,049	15,597	−30,226	−61,828	−38,049

[a]Some of the gain/loss calculations are off by one unit due to rounding.
[b]SSW = Social Security wealth; PVTAX = present value of payroll taxes; Gain/Loss = net gain or loss.

individuals aged 40, 25, and 55. The same patterns of lifetime income reallocation and redistribution that were manifest in tables 3–5 are present in tables 6–8 as well. The magnitudes of the values differ. Rather than describing the basic patterns of reallocation and redistribution again, this section will focus on the changes that occurred because of the provisions in the new legislation.

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TABLE 7

GAINS AND LOSSES FOR INDIVIDUALS AGE 25 UNDER NEW LAW
(Expressed in Present-Value Dollars in 1983)[a]

Total Earnings in 1983[b]	Family Situation				
	Husband Works	Wife Works	Both Spouses Work	Unmarried Male	Unmarried Female
$10,000					
SSW	66,383	70,323	55,304	30,483	44,580
PVTAX	40,120	41,724	40,993	40,263	41,724
Gain/Loss	26,120	28,600	14,311	−9,780	2,857
$15,000					
SSW	87,099	92,274	67,863	40,002	58,503
PVTAX	60,395	62,585	61,490	60,395	62,585
Gain/Loss	26,704	29,689	6,373	−20,393	−4,082
$20,000					
SSW	107,446	113,816	80,424	49,041	71,784
PVTAX	80,526	83,447	81,987	80,526	83,447
Gain/Loss	26,920	30,369	−1,562	−31,486	−11,663
$25,000					
SSW	116,909	123,688	92,985	53,023	77,624
PVTAX	100,658	104,309	102,483	100,658	104,309
Gain/Loss	16,251	19,379	−9,498	−47,635	−26,685
$30,000					
SSW	125,936	133,149	105,537	57,000	83,436
PVTAX	120,790	125,171	122,980	120,790	125,171
Gain/Loss	5,147	7,978	−17,443	−63,790	−41,735
$35,700					
SSW	135,434	143,162	119,338	61,271	89,682
PVTAX	141,446	146,602	146,346	141,446	146,602
Gain/Loss	−6,012	−3,440	−27,008	−80,175	−56,920

[a]Some of the gain/loss calculations are off by one unit due to rounding.
[b]SSW = Social Security wealth; PVTAX = present value of payroll taxes; Gain/Loss = net gain or loss.

Tables 6, 7, and 8 show a small increase in the present value of payroll taxes for all ages. The largest increase is approximately $660, for individuals earning the maximum taxable amount of $35,700. At other earnings levels, the increases are less. In all cases, the payroll-tax increase is a small percentage of either the present value of payroll taxes or Social Security wealth. This is to be expected, since the

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TABLE 8

GAINS AND LOSSES FOR INDIVIDUALS AGE 55 UNDER NEW LAW
(Expressed in Present-Value Dollars in 1983)[a]

Total Earnings in 1983[b]	Family Situation				
	Husband Works	Wife Works	Both Spouses Work	Unmarried Male	Unmarried Female
$10,000					
SSW	84,971	86,663	67,752	42,067	56,506
PVTAX	37,899	38,339	38,119	37,899	38,339
Gain/Loss	47,072	48,324	29,633	4,168	18,166
$15,000					
SSW	111,518	113,750	83,162	55,218	74,174
PVTAX	56,848	57,509	57,179	56,848	57,509
Gain/Loss	54,669	56,241	25,983	−1,631	16,665
$20,000					
SSW	135,464	138,169	98,572	67,098	90,178
PVTAX	73,034	73,915	76,238	73,034	73,915
Gain/Loss	62,314	64,255	22,334	−5,936	16,263
$25,000					
SSW	143,464	146,455	113,982	71,118	95,584
PVTAX	83,562	84,663	95,298	83,562	84,663
Gain/Loss	59,902	61,793	18,684	−12,444	10,921
$30,000					
SSW	148,249	151,469	129,392	73,580	98,946
PVTAX	90,948	92,269	114,357	90,948	92,269
Gain/Loss	57,300	59,200	15,035	−17,368	6,677
$35,700					
SSW	152,430	155,884	146,894	75,755	101,930
PVTAX	97,264	98,823	134,884	97,264	98,823
Gain/Loss	55,166	57,062	12,010	−21,509	3,107

[a]Some of the gain/loss calculations are off by one unit due to rounding.
[b]SSW = Social Security wealth; PVTAX = present value of payroll taxes; Gain/Loss = net gain or loss.

increases in the payroll-tax rates in 1984 and 1988–89 are a fraction of a percent.

A useful way to isolate the impacts of the other provisions in the 1983 amendments is to examine the changes in Social Security wealth for people who are now age 55 (in 1983). Individuals who are that age will not be affected by the increase in retirement age. Their benefit levels and other retirement income, particularly at low earn-

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ings levels, are not likely to trigger taxation of their Social Security benefits. Changes in Social Security wealth for 55-year-old low earners largely reflect the six-month delay of the COLA. At the $15,000 earnings level, Social Security wealth decreases by approximately $1,500 for single individuals, $2,000 for two-earner couples, and $4,000 for one-earner couples. At low earnings levels for the other age groups, the decrease in Social Security wealth includes the effects of raising the retirement age and taxing benefits.

The increase in retirement age from age 65 to 66 over the years 2000–2005 will be fully implemented when today's 40-year-olds retire. Some understanding of the magnitude of this change can be obtained by looking at changes in Social Security wealth for 40-year-olds in relation to 55-year-olds at low earnings levels. Again, the reason for looking at low earnings levels is to exclude or minimize the effect of taxing benefits. At the $15,000 earnings level, Social Security wealth declines by $3,000 to $5,000 for single individuals, by approximately $6,000 for two-earner couples, and by about $7,000 for one-earner couples. These decreases are more than twice those for 55-year-olds with the same earnings and family situations. Thus, the magnitude of the effect of raising the retirement age by one year for 40-year-olds is as large as the effect of the COLA delay. These results, based as they are on total present-value dollars, show the reduction in total benefit payments caused by the increase in retirement age.

The results for young individuals show the growing impact of the taxation of Social Security benefits. The tax burden is a function of age because Social Security benefits are indexed to the price level, and the income thresholds for taxing benefits are not. Eventually the growth in prices and the concomitant growth in Social Security benefits and other retirement income will combine to push individuals over the thresholds. This is more likely to happen to younger individuals and in greater dollar magnitudes.

A way to focus at least partially on the impact of taxing benefits is to examine what happens at the maximum level of taxable earnings. For 40-year-olds the decrease in Social Security wealth at $35,700 is more than $10,000 for two-earner couples and $10,000 to $12,000 for one-earner couples. For 25-year-olds these decreases are approximately $13,000 and $15,000 to $17,000 respectively. An important implication to draw from the greater impact of benefit taxation on younger generations is the expansion of this taxation as a source of general-revenue financing for Social Security.

In summary, the 1983 Social Security Amendments decrease lifetime income for younger generations. While 55-year-olds are affected

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only by the six-month delay in the COLA, 25-year-olds are affected not only by this delay but also by the two-year increase in retirement age and the taxation of Social Security benefits. Nonindexation of the thresholds in the taxation scheme will impose a growing burden on younger generations due to Social Security benefit taxation. As mentioned in the last section, when Social Security was established and as it grew in the early decades, large gains were conferred on beneficiaries. As the system reaches maturity and continues into the future, the treatment of younger generations will have to be less generous to amortize the start-up gains of the system.

V. Summary and Conclusion

We were motivated by a question that is important to virtually everyone: What can an individual expect to receive from Social Security? To answer this question, the concepts of Social Security wealth and the present value of payroll taxes were explained and their values were calculated for different individual cases. The results illustrate the amount individuals can expect to pay into the system and how much they can expect to receive from the system. The different examples indicate the amount of intragenerational and intergenerational redistribution taking place through the system. The results before and after the 1983 amendments document the impact of the legislation on different individuals in dollar terms.

Intragenerational redistribution can be summarized as follows.

- *Between individuals at different earnings levels.* Under the new law, there is a gain in lifetime income of $5,378 for two-earner couples (both age 40) at the $15,000 earnings level and a loss of $11,991 at the $25,000 earnings level.
- *Between men and women.* Under the new law, a 55-year-old single woman at the $25,000 earnings level can expect a $10,921 gain in lifetime income, while a 55-year-old single man at the same earnings level can expect to lose $12,444 in lifetime income.
- *Between single individuals and married couples.* Under the new law, a 40-year-old man at the $20,000 earnings level can expect to lose $29,912 if single but gain $32,229 if married to a nonworking woman of the same age. A single 40-year-old woman at the $20,000 earnings level would lose $8,748 but would gain $34,931 if she were married to a nonworking husband of the same age.
- *Between one-earner and two-earner couples.* Under the new law, a two-earner couple (both age 40) earning $25,000 split evenly between husband and wife can expect a loss of $11,991

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in lifetime income, while a one-earner couple (both age 40) can expect to gain approximately $25,000 whether it is the husband or the wife who works.

Under the old law, Social Security redistributed lifetime income from young to old. The new law continues this intergenerational redistribution of income. All generations sustain some loss in lifetime income as a result of the new law, with the decreases being proportionately greater for younger individuals.

The specific effects of the new legislation are the following.

- The increase in payroll taxes for all generations is a very small fraction of the total present value of payroll taxes they pay into the system.
- The delay in the cost-of-living adjustment of benefit payments affects current and future retirees. Before the new legislation, a future retiree could expect a COLA in the first year of retirement because it occurred in July. As a result of the new legislation, all new retirees in a particular year (starting with 1983) will have to wait until January of the following year for their first COLA. All subsequent COLAs are equally delayed. Consequently, benefit payments in 1983 and in any future year, for either current or future retirees, will be lower than they would have been under the old law.
- The increase in the retirement age reduces the total benefits paid to younger generations. The results in section IV were used to give some idea of how the increase in retirement age from 65 to 66 would affect total benefits paid to 40-year-olds. The effect of the full increase to age 67 was harder to isolate for 25-year-olds. (However, it is possible to simulate the effect of this change alone by using the prototype model.)
- The taxation of Social Security benefits has a growing impact on younger individuals. The reason for this is that the thresholds in the taxation scheme are not indexed for price changes. They stay at their nominal levels of $25,000 for a single taxpayer and $32,000 for married taxpayers. As Social Security benefits and other retirement income grow over time, more individuals will be pushed over the threshold and have their benefits taxed. The younger an individual is, the more likely he is to pay tax on his benefits and the larger the tax will be.

An important result of the 1983 amendments is that benefit taxation will expand as a source of general revenues for Social Security. The fact that younger generations will pay greater taxes on their Social

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Security benefits is not just a technical feature of the law. It is inevitable that today's young will have to bear most of the burden of achieving long-range financial solvency in Social Security. The baby boom which, because of its great numbers, is able to support the gains conferred on today's retirees cannot expect anywhere near similar gains when it retires, again because of its numbers. The gains conferred on today's retirees are the result of a Social Security system, population, and economy that were expanding and growing more rapidly in the past than can be expected in the future. The 1983 Social Security Amendments mark the beginning of the process of amortizing the start-up gains from Social Security by reducing the gains to younger generations.

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A CONSTITUTIONALIST APPROACH TO SOCIAL SECURITY REFORM

Thomas J. DiLorenzo

I. Introduction

It is well known that the Social Security system embodies two basic functions: welfare and insurance. Another well-known fact, which is often ignored in popular and academic discussions of Social Security, is that the combination of the welfare and insurance functions creates an "inherent contradiction," as described by Peter Ferrara.[1] Because Social Security has always pursued welfare objectives as well as insurance goals, it operates on a pay-as-you-go basis—Social Security taxes paid into the system are not saved or invested as with real, private insurance, but instead are paid out to current recipients, as in a welfare program. As a result, the Social Security system provides insurance benefits in a very inefficient and inequitable way, imposes major negative effects on the economy, and severely restricts individual freedom. Since Social Security diverts billions of dollars in savings to the current expenses of government, capital investment is much lower than it would otherwise be, and consequently economic growth, national income, and employment are also depressed.[2] Individual taxpayers are made worse off, since they lose the interest return they would receive if their money were invested—a return much higher than that earned on tax payments and benefits financed by future generations.[3]

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The author is assistant professor of economics, George Mason University, Fairfax, Va. 22030.

[1]Peter J. Ferrara, *Social Security: The Inherent Contradiction* (Washington, D.C.: Cato Institute, 1980).

[2]See, for example, Martin Feldstein, "Social Security, Induced Retirement, and Aggregate Capital Accumulation," *Journal of Political Economy* 82 (September/October 1974); and idem, "Social Security and Private Savings: International Evidence in an Extended Life-Cycle Model," in M. Feldstein and R. Inman, eds., *The Economics of Public Services* (New York: Halstead Press, 1977).

[3]It has been estimated that the rate of return provided by the Social Security system is approximately 10 to 15 percent of the return to private-sector alternatives. See Ferrara, chaps. 4 and 9.

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Perhaps the most serious problem created by the Social Security system stems from its coercive and compulsory nature. Because of the welfare aspects of the benefit structure, some beneficiaries get more than they are (actuarially) entitled to, while others get less. If the system were voluntary, those getting less would opt out of the system, threatening it with bankruptcy. Because the program as it is now constructed must be compulsory if it is to survive, political decision makers insist that it must be run by the government, since the government is the only institution that has such powers of coercion. Thus, the program will always operate according to political rather than economic criteria. This politicization, in fact, is the basic cause of the program's inherent instability, as will be discussed below.

Many writers have recognized the inherent instability of the Social Security system and have prescribed various "solutions," many of which are aimed at separating the welfare and insurance functions.[4] Martin Feldstein seems to appreciate more fully than others the importance of separating the welfare and insurance elements. He has proposed placing the insurance portion of Social Security on a fully funded basis with a self-supporting trust fund. But this proposal is also bound to be disappointing, should it be adopted, for it leaves the insurance function of Social Security in the domain of the government sector and subject to the forces of political manipulation.

The objective of this paper is to explain the inherent advantages, in terms of equity and efficiency, of complete privatization or "denationalization" of the old-age insurance industry. As the title indicates, the discussion will present a "constitutionalist" perspective on Social Security reform. As in so many other areas, government's excursions into the old-age insurance industry have produced many undesirable results. I contend that this situation has come about neither because the "wrong" people were in office, nor because they were misinformed, but because our democratic institutions are constrained neither by law nor by strong traditions regarding the appropriate tasks of government.[5] Government has expanded far beyond

[4]See, for example, Joseph A. Pechman, Henry J. Aaron, and Michael K. Taussig, *Social Security: Perspectives for Reform* (Washington, D.C.: Brookings Institution, 1968); and Alicia H. Munnell, *The Future of Social Security* (Washington, D.C.: Brookings Institution, 1977).

[5]The constitutionalist perspective is most commonly linked with Friedrich A. Hayek, *Law, Legislation, and Liberty*, vol. 3, *The Political Order of a Free People* (Chicago: University of Chicago Press, 1979); and James M. Buchanan, *Freedom in Constitutional Contract* (College Station, Tex.: Texas A&M University Press, 1977). For a recent discussion of the transformation of ideas regarding the appropriate role of government in the economy, see Bernard Siegan, *Economic Liberties and the Constitution* (Chicago: University of Chicago Press, 1980).

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its more limited role of protecting private property rights. It now thrives on the game of interest-group politics, whereby one group's rights are destroyed to accommodate another's in return for political support that helps keep the existing government in power. This widening of governmental powers is largely responsible for many of the destructive policies (such as Social Security) that we observe today.

The remainder of the paper will discuss the effects of the change in the constitutional setting that has allowed the nationalization of the old-age insurance industry. Section II presents some of the relevant conceptual issues from a constitutionalist perspective and discusses privatization of old-age insurance. Section III compares public and private provision of old-age insurance from a theoretical standpoint. Section IV explores the function of public advertising in the provision of Social Security and contrasts it with the role of private advertising. Section V examines the argument that compulsory governmental provision is needed because of "market failures," and section VI offers a summary and conclusions.

II. Private versus Political Provision of Old-Age Insurance: Some Conceptual Issues

The issue of whether old-age insurance is best allocated by market or by political criteria is moot to those who understand the negative consequences of the attenuation of private property rights under political resource allocation. Nevertheless, it is important to emphasize the profound differences between the market process and the political process as mechanisms for allocating resources.

The market is a process in which individuals voluntarily interact with one another in pursuit of their own interests. And with appropriately designed institutions such as well-defined, enforced, and respected property rights, freedom of contract, freedom of exchange, and the enforcement of contracts, self-interested behavior generates a spontaneous order—an order chosen by no one; yet it tends to maximize the subjective values of all the market participants. It is in this sense that the market order can be termed "efficient." The maximization of subjective values, *as individuals themselves perceive them,* is the result of the market process and is not something that can be defined or "maximized" by some outside observer. A point worth emphasizing is that self-interested behavior does provide individuals with incentives to cheat, to defraud, or to default, but as James Buchanan[6] has pointed out, laws, customs, traditions, or moral

[6]James M. Buchanan, "Notes on Politics as Process" (Paper presented at the 1983 meeting of the Public Choice Society, Savannah, Ga., March 25, 1983).

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precepts have been constructed or have evolved to limit such behavior in the market. Thus an overriding function of government is to establish the "rules of the game," and to define and protect property rights, the freedom of exchange, and freedom of contract so as to facilitate mutually advantageous trade.[7] The successful performance of this function, along with generally agreed-upon norms regarding the illegitimacy of cheating and defrauding one's partners in exchange, strengthens the market process and enhances individual welfare.

By contrast, there simply are no such constraints imposed upon "political exchange." It is rare indeed that a politician is prosecuted for bribery, corruption, fraud, or dishonesty. Who would create such laws, and who would enforce them but politicians themselves? In politics, ownership rights are not respected. In fact, the state seems to operate on the notion that those within government lay claim to all property rights, and have the power to rearrange these rights as they see fit. This is not a "devil theory" of government. Politicians and bureaucrats are, as individuals, no different from the rest of us. They prefer more rights to the use of resources to fewer and are utility maximizers, just as we all are. But the utility of the politician or bureaucrat, operating in the world of "political exchange," is not necessarily enhanced primarily by ownership rights in some goods or services, as in the private market. Politicians and bureaucrats use their positions in government to bestow special rights or privileges on politically active individuals or groups in exchange for votes, campaign contributions, and other forms of political support.[8] Those whose rights are consequently abridged are usually those who are not well organized politically. The revocation or destruction of property rights is the business of modern politics, and politicians are continually seeking to expand the market for their "services." Stability in private property rights is anathema to politicians and bureaucrats, for it imposes constraints on their abilities to accumulate power and wealth.

The Social Security system currently consumes a large part of taxable income and therefore represents a significant infringement of individual rights by government. Since the system is compulsory, individuals are denied the right to control a large portion of their incomes. And, more important for our purposes, they are prohibited

[7]This is not to imply that government is necessarily the only institution that can perform these tasks. Many have argued that private courts, for example, would be superior to the present system.

[8]For a more general discussion of this phenomenon, see Michael C. Jensen and William H. Meckling, "Can the Corporation Survive?" *Financial Analysts Journal* (January/February 1978): 31–37.

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from choosing other means of purchasing old-age insurance. The important point is that by its very nature, compulsory government provision of old-age insurance is "inefficient" and therefore reduces individual welfare. If old-age insurance were provided privately, the appropriate role for government would be the more limited one of protecting economic liberties in that and other markets. Currently, the government has revoked those rights—rights that many throughout society have recognized as important. As Peter Ferrara has stated:

> It should be apparent that the coercive nature of social security violates all of these rights. It forces individuals to enter into contracts, exchanges, and associations with the government that they should have the right to refuse. It prohibits individuals from entering into alternative contracts, exchanges, and associations with others concerning the portion of their incomes that social security consumes. It prevents individuals from choosing courses of action other than participation in social security, although these courses of action will hurt no one . . . The program . . . operates by the use of force and coercion against individuals rather than through voluntary consent. The social security program thus restricts individual liberty in major and significant ways. . . .[9]

From a constitutionalist perspective, it is the enforcement and protection of these rights through the rule of law that is necessary to prevent government from further abusing its power by manipulating the Social Security system for political gain. Such a rule of law may be either written or unwritten, but it will only be enforced if it has the approval of at least a majority of the electorate. In short, as argued below, what is essential to meaningfully address the Social Security dilemma is a change in the constitutional setting. Such a change would require that citizens come to realize the importance of *economic* liberties, such as the freedom to control a large portion of one's income, and to prohibit the further political plundering of these and other freedoms. For once the government extends its powers beyond the protection of basic rights and enters the realm of legislation and regulation, more and more freedoms are denied, and individual welfare is reduced.

III. The Political Economy of Privatization: The Case of Old-Age Insurance

Many taxpayers are made worse off because the old-age-insurance industry is monopolized by government. These individuals would therefore benefit if privatization were allowed. Unfortunately, tax-

[9]Ferrara, p. 275.

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payers are generally poorly organized politically and will therefore find it difficult (though by no means impossible) to achieve privatization. Among the major beneficiaries of governmental control of the old-age insurance industry are Social Security Administration (SSA) bureaucrats. Bureaucrats are basically no different from other individuals; their primary objective is to enhance their own self-interest. Public employees, however, face a starkly different institutional setting than their private-sector counterparts. This difference explains why government provision of old-age insurance is likely to be more costly and of a lower quality than private provision. In the private sector, the manager (of an insurance company) who tries to minimize the cost to his customers is rewarded by profits, as cost reductions increase his price/cost margin. Profits may benefit the manager directly, should he be a part owner of the firm, or indirectly in the form of more frequent promotions and salary increases. Further, the private managers who do not strive to minimize costs and to produce a high-quality product will be penalized by the loss of profits. Managerial labor markets also promote cost minimization, because the firms that do not reward managerial talent will lose that talent (along with the profit-making opportunities) to competing firms.

The market for corporate control is yet another device that creates pressures for cost-minimizing behavior, because managers who do not strive to maximize the value of the firm (by giving the consumers what they want at least cost) run the risk of being replaced through the mechanism of a takeover bid.[10] Finally, the survivor principle dictates that the private firms that do not strive to provide high-quality products at least cost in competitive markets will, in the long run, simply not survive. In sum, private-sector institutions provide strong incentives for firms to offer old-age insurance in a least-cost way and to cater to the preferences of their customers.

By contrast, no such institutional arrangements exist in the public sector. There are no profits, by definition, in the public sector. A growing body of literature on the economics of bureaucracy[11] explains, however, that in the absence of the profit incentive, utility-maximizing public bureaucrats will pursue the objective of increasing their consumption of perquisites such as staff, travel allowances, on-the-job leisure, and so on. And all of these items are more likely to be

[10]See Henry Manne, "Mergers and the Market for Corporate Control," *Journal of Political Economy* 73 (April 1965): 110–20.

[11]See Ludwig von Mises, *Bureaucracy*, 2d ed. (Westport, Conn.: Arlington House Publishers, 1969); Gordon Tullock, *The Politics of Bureaucracy* (Washington, D.C.: Public Affairs Press, 1965); and William Niskanen, *Bureaucracy and Representative Government* (Chicago: Aldine-Atherton Press, 1971).

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obtained with a larger budget for the bureau. Thus, public-sector bureaucrats such as those at the SSA are likely to act so as to maximize discretionary revenues—the excess revenues beyond the cost of providing old-age insurance—and to have a strong preference for on-the-job leisure, since the price of leisure is lower in the public sector than in the private sector. Consequently, the SSA has little incentive to make changes that will better serve the needs of its "customers." Such changes would be time consuming and costly for the SSA whereas the benefits, in terms of the probability of achieving a larger budget, would be very small. There is little, if anything, the SSA can gain by improving service to the taxpayers.

This bureaucratic attitude explains why the overall quality of government-provided services has the poor reputation it does. The SSA bureaucrats can more profitably spend their time (from *their* perspective) convincing the Congress and the public (through publications and advertisements) that government old-age insurance provides benefits far greater than what it actually provides, so as to make their own positions (and budget) more secure. These bureaucrats are among the major beneficiaries of the Social Security monopoly. Unlike private monopolists, however, they not only charge a monopoly price but also have the power to force consumers to pay it. Government has often been referred to as the monopolist par excellence, and the SSA lives up to that image.

In addition to solving the problems of bureaucratic incentives and monopoly power, a private system would be a more effective way of permitting consumers to articulate their diverse demands for old-age insurance. Each individual could purchase different amounts and types of insurance, according to his preferences. By contrast, the current system entails a tremendous welfare loss, since it imposes one set of benefit provisions on everyone. The inefficiency of this system is readily apparent. Single workers must pay for survivors insurance that they do not need—if an unmarried worker (with no children) dies, nothing is paid in his name, despite years of contributions; single people must buy the same amount of insurance as married people; people without children pay the same as those with children; those in low-risk occupations contribute as much as those who work in high-risk jobs, and so on. The list is almost endless.

A further problem is that there is no relation between (tax) prices paid and benefits received. Unlike the private sector, where consumers could trade off different types of insurance coverage and other goods depending on their incomes, preferences, and relative prices, the "price" of Social Security is determined by current benefit levels, and no tradeoffs are allowed. Furthermore, the true price of Social

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Security is well hidden from the average taxpayer, who is not likely to know that he himself pays for his "employer's contribution" in the form of lower wages. Not to mention the fact that the true opportunity cost would include the (private) return he could have earned under a private system and the effects of reduced capital accumulation and economic growth.

If individuals prefer a change in the types of benefits provided by the Social Security system, they must bear the costs of becoming informed about the current system and must discover what politicians are promising to do about it. Finally, they must bear the cost of becoming part of an organized coalition powerful enough to influence legislation. These transactions costs are inordinately high compared to those in the private market, which is far more conducive to making marginal adjustments.

Government provision of old-age insurance will also necessarily result in an inequitable distribution of benefits, since the distribution will be shaped according to the preferences of the groups with the most political clout. Those who are not well organized and well financed will always be the net losers. As Peter Ferrara has shown, this group includes women, blacks, the poor, the young, and, ironically, many of the elderly, who would be better off with the right to invest their funds as they see fit. By inflicting costs on these groups, the Social Security system may very well have sown the seeds of its own demise, for beyond some point the marginal benefits to these and other groups of securing truly effective reform via privatization will outweigh the marginal transactions costs. Perhaps then politicians will finally begin to feel the heat. And as the late Senator Everett Dirksen once said, "When politicians begin to feel the heat, they begin to see the light."

IV. The Role of Public Advertising

One aspect of Social Security that has generated much criticism is the use of allegedly misleading advertising by the SSA. Advertising plays a prominent role in both the private and public sectors, although the net effects are quite different in the two settings. In the private sector, insurance companies advertise primarily to provide information regarding product quality and prices, since consumers typically have very limited knowledge of the alternative products available to them. Furthermore, the firms with the most reliable products are likely to advertise most heavily, for they have the most to gain from repeat sales.[12] There is also considerable evidence that adver-

[12]See Yale Brozen, "Advertising, Competition, and the Consumer," *Intercollegiate Review* 8 (Summer 1973): 235–42.

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tising makes the economy more competitive by facilitating comparison shopping.[13] Economic research has revealed, in fact, that legislative *restrictions* on advertising tend to lessen competitive pressures and to *raise* prices. And, although much fraudulent or misleading advertising exists, as long as the consumer has the option of comparing and contrasting competing claims of advertisers he is unlikely to be continually misled or "exploited." Market competition protects the consumer from fraudulent advertising, although there are also legal restrictions on such behavior. In fact, private advertising is one of the most heavily regulated economic activities.

Is it also true that government advertising by agencies such as the SSA is on a par with private advertising? That is, does it aim to inform citizens of available alternatives? The answer to this question is an unequivocal no, since the consumers of Social Security have no market choice. Like most other services provided by government, old-age insurance is monopolized: The consumer has no choice between the SSA and a private insurance company. He must continue to pay Social Security taxes regardless of which alternative he may prefer.

Since the SSA does spend large sums on advertising, the question becomes: Are politicians and bureaucrats held legally liable for *their* promises, as they insist their private-sector counterparts should be? As Richard E. Wagner pointed out in a most original analysis of the role of public advertising:

> Politicians cannot be held liable for their promises. If a hot dog manufacturer's all-meat product turns out to be 30 percent chicken and bread crumbs, he will most likely encounter difficulty with the government, even if consumers buy the product. But when the government's comparable product turns out to be 60 percent baloney, no regulatory agency will take action.[14]

This, of course, is not to suggest that more regulation is needed. The point is that politicians and bureaucrats are not in fact held liable for false advertising, and the SSA is among the most serious offenders. In a now-famous statement from a booklet published by the SSA we are told:

> The basic idea of Social Security is a simple one: during working years employees, their employers, and self-employed people pay

[13]See Lee Benham, "The Effect of Advertising on the Price of Eyeglasses," *Journal of Law and Economics* 15 (October 1972): 337–52; and Yale Brozen, *Concentration, Mergers, and Public Policy* (New York: Macmillan, 1982).

[14]Richard E. Wagner, "Advertising and the Public Economy: Some Preliminary Ruminations," in David Tuerck, ed., *The Political Economy of Advertising* (Washington, D.C.: American Enterprise Institute, 1976), pp. 81–100.

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> Social Security contributions into special trust funds. When earnings stop or are reduced because the worker retires, dies, or becomes disabled, monthly cash benefits are paid to replace part of the earnings his family has lost.[15]

Similar statements are made through government campaigns, the press, and on radio and television. As Milton Friedman has said, however, it would be hard to pack a greater number of false and misleading statements into a single paragraph. Individuals do not pay Social Security "contributions." *Contributions* are voluntary; Social Security taxes are not—and failure to pay them will result in fines, imprisonment, or both. Furthermore, employers do not pay "their share" of Social Security taxes; the burden of taxation is ultimately shifted to the wage earner.[16] The above paragraph also gives one the impression that the "special trust funds" are actually sums of money that are saved and invested much like private pension funds, rather than being immediately paid out in benefits. Finally, one also gets the impression that one's future benefits will be paid from the "trust funds" and that such benefits are guaranteed. In reality, the only guarantee is the willingness and ability of future generations to pay Social Security taxes.

Apparently, the purpose of such advertising is to mislead the public into believing that Social Security is in fact equivalent to private insurance. Perhaps that is why we are told that Social Security cards are "the symbol of your insurance policy under the federal Social Security Law."[17] Because of the absence of market constraints, and because politicians and bureaucrats themselves are "responsible" for enforcing laws or standards regarding false and misleading advertising by government, such activities can be expected to continue throughout the SSA in particular and the government generally.

Another effect of misleading advertising by the SSA stems from the fact that Social Security benefits, like the benefits of most governmental services, fall into the category of goods economists call "credence services."[18] These are services whose quality is difficult to judge. Many private services, e.g., car repair, fall into this category, and individuals can be induced to pay more for the service if they are unsure about the quality. The unsuspecting motorist who thinks

[15]U.S. Department of Health, Education, and Welfare, *Your Social Security* (Washington, D.C., June 1976), as cited in Ferrara, p. 66.

[16]Ibid.

[17]Warren Shore, *Social Security: The Fraud in Your Future* (New York: Macmillan, 1975), p. 21.

[18]Michael Darby and Edi Karni, "Free Competition and the Optimal Amount of Fraud," *Journal of Law and Economics* 16 (April 1973): 67–88.

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that all he needs is an oil change has more than once been counseled into an engine overhaul, although competitive pressures make this behavior costly to the station owner and will therefore limit it. One would expect this type of fraudulent behavior to be even more widespread in the public sector, however, because of the difficulty of evaluating services *and* the absence of market alternatives.

In light of all this, just what is the function of public advertising as practiced by the SSA? Richard Wagner seems to have it right:

> [T]he principal function of public advertising would seem to be to promote acquiescence about the prevailing public policies. The purpose of public advertising would be to reassure citizens that the fact that their public goods are composed of 60 percent baloney indicates good performance.[19]

Thus, while the Social Security system impairs individual wealth and freedom and exerts a strong negative influence on the economy, the role of political advertising is to draw the public's attention away from these realities, so as to enhance the prospects for further growth of the Social Security bureaucracy. Such advertising hides the welfare aspects of the program. By emphasizing (contrary to fact) that Social Security is like an insurance program and that Social Security taxes are like insurance premiums, the SSA obscures the true costs of the program. This increases the political acceptability of the current program and provides more security not for the elderly, but for the Social Security bureaucracy.

V. The Provision of Old-Age Insurance: A Case of Market Failure?

There have been numerous rationales advanced for the governmental provision of old-age insurance to the exclusion of private provision, including the "forced savings" argument, welfare and redistributionist rationales, the alleged superiority of a pay-as-you-go system that must be governmentally provided, and the desirability of intergenerational transfers. All of these rationales have been widely discussed elsewhere, but yet another is of particular relevance to the privatization issue and will therefore be dealt with here. Namely, the argument has been made that government provision of old-age insurance is necessary because of market imperfections that would make private-sector alternatives unattractive or unavailable. This is the classic "market failure" rationale for government intervention. One alleged market inefficiency stems from the fact that those who

[19]Wagner, p. 97.

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anticipate a long life may purchase annuities heavily, which will increase the rates charged these individuals and to others. The "average" person may therefore be treated "unfairly" or be priced out of the market and will be left without the protection provided him by Social Security. Thus it is alleged that an "adverse selection" problem exists. However, actuarial rates are based on characteristics of *groups* of purchasers, not on particular individuals. Those who are expected to live longer (i.e., women) can expect to be charged higher rates than those with lower expected life spans. *Prohibiting* such arrangements by government mandate, however, would cause what one might call a *government-induced* market "failure."[20]

Even if private markets would not emerge for certain groups of individuals (which is mere conjecture), one cannot argue for compulsory governmental provision on the grounds of economic efficiency. For in order for any change to be economically efficient, it must make someone better off without making anyone worse off. That is why voluntary trade is efficient, but it also explains why governmental provision of old-age insurance could never be, for that would require unanimous consent. In light of the fact that private alternatives would yield several times the return to Social Security, unanimous agreement to maintain the current system would be impossible. The case for prohibiting privatization can only be based on coercion, not efficiency, as conventionally defined.

A second "market failure" argument is based on the idea that since individuals do not have perfect information about market alternatives, and since information is costly, government provision is needed. Information is a public good, so it is said, so that the market "fails" in this respect to provide the optimum quantity. This particular line of reasoning commits what Harold Demsetz called the "nirvana fallacy": If one compares a world of perfection with the real world, the real world will invariably turn out to be imperfect or inefficient.[21] In fact, the market process best facilitates the use of knowledge in society.[22] No group of governmental planners at the Social Security Administration could ever make efficient use of all the constantly

[20]As a similar phenomenon, a group of women are currently suing their insurance company for charging them higher health-insurance rates than men with similar medical histories because of the fact that women live, on average, about 10 years longer than men. If this practice is ruled illegal, insurance companies will be apt to offer less medical insurance to women in the future.

[21]Harold Demsetz, "Information and Efficiency: Another Viewpoint," *Journal of Law and Economics* 12 (April 1969): 1–22.

[22]Friedrich A. Hayek, "The Use of Knowledge in Society," *American Economic Review* 35 (September 1945): 519–30.

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changing information that exists *in the minds* of consumers. Only individuals themselves can make such decisions, and the private market is the only known mechanism that can facilitate this process. Once individuals decided what the "appropriate" retirement age is, when to start buying old-age insurance, etc., private firms would meet the demand. Increased demand for certain types of policies would be reflected in higher relative prices, which would induce a greater supply.

By contrast, given that personal preferences vary widely, the uniform provision of one kind of old-age insurance by the government would satisfy the preferences of relatively few. It is the government that is a major source of inefficiency in the use of information. Governmental provision, by definition, cannot accommodate the diversity of preferences that exists in the world. More important, governmental provision totally subverts the role of the price system in conveying the relevant information. It simply substitutes the preferences of bureaucrats for those of consumers, as conveyed by the price system. When one judges the efficiency of the private insurance market by a benchmark of omniscience, one is quite naturally led to the conclusion that the market "fails." But from the standpoint of reality, it is well known that the private market is much more accommodating to diversity of preferences than the bureaucracy is.

In sum, it appears that the "market failure" arguments in favor of compulsory governmental provision of old-age insurance rest on very weak ground. They are, however, rather typical products of an entire industry that has evolved, wherein welfare economists concoct an ever-increasing volume of excuses for governmental coercion to promote ends with which they personally agree. It appears that such arguments are nothing but attempts to ease the consciences of those who make them.[23]

A radical departure from orthodox welfare economics, developed by Ken Shepsle,[24] provides what I believe to be a more accurate explanation of why the insurance component of Social Security is nationalized. While much has been made of the polar distinction between public and private goods and problems of externalities and other "market failures" in discussions of the "appropriate" role of government in the economy, Shepsle notes that *all* goods are mixes

[23]For an elaboration of this view, see T. Nicolaus Tideman, "Toward a Restructuring of Normative Economics," working paper, Department of Economics, Virginia Polytechnic Institute, 1983.

[24]Kenneth Shepsle, "The Private Use of Public Interest," mimeographed (Center for the Study of American Business, Washington University-St. Louis, 1978).

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of publicness and privateness, and most processes of production and consumption generate externalities. But the governmental response to these problems is generally idiosyncratic: Some externalities are regulated, others are not; some goods with attributes of publicness are provided by government, others are not; and many private goods are provided by government. In short, welfare economics has little to do with *actual* governmental decisions to intervene in private markets. Among the factors that *are* decisive, according to Shepsle, are the opportunities for coalition building by those who stand to benefit from the program, the abilities of political entrepreneurs to enact the programs (with which they hope to enhance their terms in office), and the ability to extol arguments exaggerating market failure and emphasizing the "need" for intervention.

Although Social Security has recently become somewhat of a political albatross, it was, for many years, a political gold mine. (Of course, it is still manipulated to secure votes.) For years the program has been a means of dispensing benefits to *current* voters at the expense of future generations, who of course cannot object. From the very start, the system was used by politicians to advance their political interests. Politicians convinced the public that the system would be run on a fully funded basis, but that promise was soon broken. Congress has voted benefit increases without accompanying tax increases in nearly every election year,[25] so that the system is now on the verge of financial collapse. Allowing privatization would impair the empire-building capacities of politicians; that is why the Greenspan Commission did not even consider it.

Special-interest groups have also played an important role in shaping the Social Security system, by lobbying for particularized benefits and for ideological benefits such as increased welfare spending. Of course, the most important interest group is current beneficiaries, who are arguably the strongest political force in the nation, and who provide opposition to any significant proposals for change.

Finally, as with all government programs, those who intend to run the program are the foremost lobbyists in support of it.[26] This was

[25]Ferrara, p. 253.

[26]A current example of this time-worn tradition is the crusade to revitalize Herbert Hoover's Reconstruction Finance Corporation (RFC). I recently discussed a paper of mine on that subject at the U.S. Chamber of Commerce in Washington, D.C. Judging from the Chamber's magazine and television shows, one gets the impression that it is a bastion of free-market capitalism. However, at that meeting I found that many, though not all, of the Chamber's board members, along with several former bureaucrats in attendance, were staunch advocates of more centralized economic planning "if only done correctly." Several people there offered detailed scenarios of how they, as central planners, would decide which industries should survive through government subsidization and which should not.

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certainly true at the system's inception, and few would dispute the fact that the SSA bureaucracy spends much of its time and effort exaggerating the "necessity" of maintaining the status quo (but with a bigger budget) and discouraging privatization.

In summary, the market-failure arguments in support of governmental provision of the insurance element of Social Security do not stand up to close scrutiny. It is doubtful that a problem of adverse selection would be of any consequence under privatization, and even if it were, one could not argue for mandatory governmental provision on efficiency grounds, for efficiency requires unanimous consent. Nor can one claim that imperfect information is cause for governmental intervention, for private markets have proven to be far superior to government bureaucracies in the use of knowledge—knowledge that can be transmitted only via the price system. The case for compulsory governmental provision of old-age insurance is based on coercion, not efficiency or equity. In particular, the main impact of the current system is to redistribute wealth, not to provide insurance, and the motivation for this system is, I believe, that the people who benefit from the transfers want them and are adept at using the powers of the state to secure them.[27] The net losers are all those who do not receive particularized benefits but who must nevertheless continue to pay taxes and experience the effects of slower economic growth.[28]

VI. Summary and Conclusions

It does not appear that the Social Security crisis can be dealt with by manipulating the benefit structure or the tax structure every five years or so. At best, this strategy postpones the day of reckoning and permits politicians to stand on the brink of disaster, piously claiming they have saved everyone's Social Security. As discussed above, a first step toward effective reform is the complete privatization of the insurance element of Social Security. Privatization would provide benefits more tailored to individual preferences and a higher return on investment, and would stimulate private savings, capital accumulation, and economic growth.

What are the prospects for real reform? The recent actions of the Reagan administration, Congress, and the Greenspan Commission

[27]This, in fact, is the primary reason for most redistributive programs of the government. See Gordon Tullock, *Economics of Income Redistribution* (Boston: Kluwer-Nijhoff, 1983).

[28]Ferrara, chap. 6.

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convey pessimism. Politics-as-usual has produced yet another short-term remedy for a long-term illness. But I am not pessimistic. The key to understanding the nature of the problem is to recognize that a major reason for this and other *government failures* is that there has been a change in the constitutional setting. A skirmish in the battle of ideas, if you will, has been won by those who prefer more centralized control over the economy and a redistribution of wealth to themselves and to other favored groups. A change in public attitutes occurred, beginning in the earlier part of this century, which allowed politicians to abandon their roles as agents whose primary task was to protect private property rights and to defend the rights of freedom of exchange and freedom of contract.[29] Instead, they became more brazen in their attempts to revoke individual rights for political gain, and the nationalization of the old-age-insurance industry was permitted to take place.

Thus, what is necessary for truly effective reform is yet another change in the constitutional setting. The value of limited government was understood by writers such as Thomas Jefferson and James Madison, as well as many of their contemporaries. Economic liberties must once again be appreciated and accorded the same respect that civil liberties seem to be given. This may not be as difficult a task as it might appear at first. As mentioned above, the tremendous costs imposed on individuals in all segments of the population by the old-age insurance monopoly will provide them with incentives to investigate and eventually advocate the privatization alternative.

A number of very distinguished authors have misunderstood or ignored this basic point, and some have even declared Social Security to be the most successful government program ever. That may be true, but it in no way means that citizens would not be far better off without it. Furthermore, it is often claimed that the existing system is successful because "it has majority approval." But as Friedrich Hayek has noted, representative democracy under majority rule, although it is our only protection against tyranny, does not produce what the majority wants. Rather it produces what each of the interest groups making up the majority must concede to the others to get their support for what it wants itself.[30] Government policy is largely determined by a series of deals with special interests, and Social Security

[29]This change in the constitutional setting has also led to many of our general economic problems caused by the government's monetary and fiscal policies. See James M. Buchanan and Richard Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (New York: Academic Press, 1977).

[30]Hayek, *Law, Legislation, and Liberty*, vol. 3, p. 11.

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is no exception. In fact, Hayek further noted, majority rule is a meaningful phrase only if used to describe agreement on general rules of law, not legislation, because the amount of information necessary to make truly informed decisions about legislation (i.e., the effects of the Social Security system) is prohibitive. By contrast, individuals do have a conception of the *general* direction they would like their government to go in, and the protection of rights to life, liberty, and property is one direction that has wide acceptance. The immediate problem facing the political economist and other concerned citizens is to bring to the attention of the citizenry the fact that these rights have been revoked by the Social Security system and other governmental interventions and should be reinstated immediately.

Finally, recent events have hinted at prospects for effective reform, for Congress recently voted to place itself and a large part of the federal bureaucracy under the umbrella (web?) of the Social Security system. On this matter, the authors of *Cato's Letters* said of politicians:

> [W]hen they make no laws but what they themselves and their posterity must be subject to; when they can give no money, but what they must pay their share of; when they can do no mischief, but what must fall upon their own heads in common with their countrymen; their principals may expect then good laws, little mischief, and much frugality.[31]

I am generally proud of the fact that I do not consider myself to be an economic forecaster, but I would like to offer a political forecast. Soon after the 1984 elections, Congress will either attach an amendment to a strip-mining bill that will exclude members of Congress from Social Security, start up a "supplemental" retirement program for themselves (perhaps by altering the campaign finance laws), or seriously consider privatization. In any event, the taxpayer will benefit; for if either of the former two options is chosen, Congress itself will help to expose the Social Security system for the fraud that it is.

[31]*Cato's Letters*, letter 62 (January 20, 1721), p. 128, as cited in Hayek, *Law, Legislation, and Liberty*, vol. 3, p. 9.

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EXPLAINING SOCIAL SECURITY GROWTH

Rudolph G. Penner

Conservatives have a problem. They dislike big government, especially as it intrudes on individual freedom, and they believe the American public must share their tastes, since those tastes are so reasonable. It becomes hard, therefore, to explain why government is so large. Fascinating theories of the role of special-interest groups, bureaucratic behavior, and monopolistic government advertising have emerged to explain the growth of government. DiLorenzo employs these theories to explain how Social Security got so large.

I was once quite enamored of such theories. They represent an important intellectual achievement; some are quite elegant. They also contain more than a small grain of truth. However, I have more recently made a profession of studying budget numbers, and unfortunately the theories that I used to like do not do a very good job of explaining more than a tiny fraction of what is going on. The hypothesis that most of the public likes big government and does not care much for individual freedom seems more consistent with facts.

Take the theory of special-interest groups. Certainly such groups exist, and certainly they distort government decisions. They influence spending, regulatory, and tax decisions; and I believe it is fairly clear that they distort the allocation of resources. It is somewhat more difficult to know how this affects the *level* of government spending, but I suspect it is biased upward. The questions, "How big is the bias?" and "How does it affect Social Security?" are harder to answer. I find it difficult to apply the theory of special-interest groups to explain very much of the astounding growth of Social Security, but that theory might help explain the design of the present benefit structure.

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The author is resident scholar and director of fiscal policy studies, American Enterprise Institute, Washington, D.C. 20036.

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The problem with applying the theory of special-interest groups to explain the growth of Social Security is as follows. A crucial element of the theory is that special-interest groups can successfully work for programs that concentrate sizable benefits on a few individuals while diffusing the costs over many individuals, so that the latter do not find it worthwhile to get organized in opposition to the program. But this element of the theory obviously does not fit Social Security. The benefits are not concentrated on a very narrow group. Those with a direct financial interest (in the sense that the rate of return to all future payments is very high) include the 36 million already benefiting, those nearing beneficiary status, and the relatives who would otherwise have to contribute some support.

On the tax side, the costs are certainly not diffused enough that they are not burdensome. The program is financed by a highly visible, earmarked tax that has risen so much that a majority of taxpayers pay more in payroll taxes than in income taxes. Not only was there no tax revolt associated with the large increase in this highly visible and burdensome tax, but most of the public responded to opinion polls saying that more should be done for the elderly even if it meant higher tax rates. The Social Security issue was at the forefront of the 1982 election, and politicians promising to preserve benefits clearly prospered at the expense of those who did not. It would be preposterous to argue that the taxpayers who were financing the increased benefits did not know what was going on. The basic point is that most taxpayers seem quite willing to pay, as long as they expect their future benefits to be adequate.

As an aside, I note that the theory of special-interest groups may explain why government is too large, but it is hard to use the theory to explain why government has grown to its present size. What I would call programs purely for special-interest groups—programs in agriculture, the merchant marine, import aid, and so on—are taking up a diminishing share of the budget and of Gross National Product, as more popular programs (aimed at much broader groups) crowd them out. I am sure that we can all think of exceptions, but I think the expansion of programs providing very concentrated benefits and diffused costs is the exception rather than the rule. The highly concentrated grants-in-aid programs are an interesting example. Many fit the model of special-interest groups quite well, but in relation to GNP these programs were cut significantly in both the Carter and Reagan administrations.

Does the theory of bureaucracy help explain the growth of Social Security? DiLorenzo claims that bureaucrats "pursue the objective of increasing their consumption of perquisites such as staff, travel

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allowances, on-the-job leisure and so on."[1] They may pursue such things, but they certainly are not very successful. There is now less employment in the federal executive branch than 15 years ago, despite a vast expansion in the level of spending and the number of federal programs. (Someone will mention outside contracting, but that is not nearly as much fun as having your own staff.) Travel budgets have been cut to a level that would be considered ridiculously low in private firms with similar responsibilities. I have no evidence concerning on-the-job leisure. I suspect that it is high, but I doubt that it is growing.

What about monopolistic advertising as an explanation of the growth of Social Security? I seriously doubt that people are so naive as to believe everything they are told in government advertising about Social Security. If I believed that advertising, I would not have much confidence in private markets either. But even if one believes that the theory of monopolistic advertising is important, it does not help explain why Social Security grows so explosively while other programs, like those of NASA (with its hordes of highly skilled PR people) shrink in relation to the size of the economy and the rest of the budget.

If the above theories do not explain the growth of Social Security, how then can we explain it? If people like Social Security so much, why do they like it (given all of its faults, so excellently outlined by DiLorenzo)? Why was it invented in the 1930s, and not in the 1890s or the 1920s or the 1950s?

At this point I become very tentative, although I do believe that DiLorenzo's arguments are based on a fundamental misconception of what Social Security is all about. His paper portrays it as a compulsory system that is a substitute for private insurance sold in competitive markets. But privately sold insurance was not a major alternative to Social Security before it was invented, and I doubt that private insurance would be the main means of financing retirement today—although I admit that it would play a more important role than in the pre-World War II era.

The main technique for financing the elderly before Social Security (and indeed, since the beginning of time) was transfers from children to their parents. This was not a free-market arrangement. It was a type of social contract arrived at as the result of a collective decision-making process. Some element of compulsion, if only that emanating from social pressures, was involved. In other words, the alternative

[1]Thomas J. DiLorenzo, "A Constitutionalist Approach to Social Security Reform," *Cato Journal* 3 (Fall 1983): 449.

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to Social Security has never been and would not now entirely be a private insurance market conferring complete freedom of choice. The alternative would be a system of social relationships that generated much tension between parents and children and contained many uncertainties, since the children might die before their parents, might become disabled, or might even rebel and violate the social contract.

If one sees government tyranny regarding Social Security not as an alternative to individual freedom and competitive markets but as a more secure alternative to family tyranny, it becomes much easier to understand the popularity of Social Security and its explosive growth. Indeed, when I have spoken on radio talk shows, advocating a slowdown in the growth of benefits, many of the angriest calls have come not from recipients, but from the children of recipients.

But why did the program start in the 1930s? Why did the level of retirement benefits stagnate in the 1940s, 1950s, and early 1960s? Why did the level of benefits soar in the late 1960s and early 1970s and why was it cut back in relation to income (if ever so slightly) in the late 1970s and early 1980s? I do not pretend to have reliable answers. But one can speculate that the social contract between parents and children was frequently violated during the economic duress of the 1930s, and that the state moved in essentially to enforce the social contract on a depersonalized basis.

But something else may have been going on as well. When it comes to explaining how government grows, I find the theories of E. G. West most provocative. Studying the nationalization of elementary education in the United Kingdom in the 19th century, he notes that it would have been impossible to offer state-financed education to all were it not for the fact that almost everyone was already being educated privately by free enterprise or by charitable and religious organizations. The marginal resource cost of universal education was small because the teachers, books, buildings, and so forth, were already there. If no one had been educated previously, the adjustment costs to the economy would have been enormous.[2]

It might be interesting to investigate the lifestyle of the elderly in the 1920s, to find out how they were supported and at what level. It may be that Social Security did not yield much of an improvement in the living standards of the elderly in relation to the conditions of the 1920s, although the improvement may have been significant compared to what living standards would otherwise have been in the 1930s.

[2]See E.G. West, *Education and the State* (London: The Institute of Economic Affairs, 1965).

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The main point is to the extent that the system is a substitute for previous systems, it does not impose an additional resource cost. There is some additional cost because the system becomes completely universal. In return, however, it does provide a great deal more security. It now even provides protection against inflation—protection that is costly to arrange on private markets or within the family.

The bottom line, I believe, is that Social Security is a truly popular program. Ordinary people are quite willing to give up individual freedom in return for more security, in part because they place less emphasis on freedom than we intellectuals do. But more important, alternative family arrangements are not free of compulsion.

Does that necessarily mean that the system is now perfect and should not be reformed or constrained? Of course not. Earlier I belittled theories of special-interest groups and bureaucratic behavior. But there is more than a grain of truth there—benefits may have been distorted and the nationalized tax-transfer system may in some ways be less efficient than a family's tax-transfer system.

Is Social Security too large? In its absence, would children support their parents at comparable levels? Such questions very rapidly become metaphysical. Social Security has had a profound impact on our society and (among other things) has probably played a very important role in explaining falling birth rates. It is hard to imagine how the world would appear without this system. But such an exercise of imagination is unnecessary. Anyone who believes that radical reforms of the Social Security system are possible is already living in an imaginary world.

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SOCIAL SECURITY: THE ABSENCE OF LASTING REFORM

Richard B. McKenzie

Introduction

Criticisms of the conceptual basis and actual operations of the Social Security system are extensive and severe. The system is on the verge of bankruptcy. Unless projected benefits are curbed, it portends dramatic payroll-tax increases. Social Security redistributes income from those who earn their livelihood to those who do not. The system fails to adequately aid the elderly who are truly in need. It widens the tax wedge between the wage paid to laborers and the value of their labor in the workplace, thereby distorting the allocation of workers' time between productive and leisure activities. It is a fraud, a pay-as-you-go welfare system that has been and continues to be advertised to the American taxpaying public as an insurance program. The system is paternalistic. It employs government coercion, requiring people who may not wish to provide for their retirement to do what others want them to do. The system, as a set of government-established rules and procedures applicable to everyone, imposes costs and provides benefits that because of their uniformity cannot meet very well the individual needs of a diverse population.

According to its critics, Social Security reduces savings, discourages investment, dampens economic growth, and effectively imposes a tax on future generations, who are politically trapped into signing—by means of their vote—what amounts to an intergenerational social-welfare chain letter. Practically all computations of most future workers' expected rates of return on their Social Security "investment" (using the term loosely) lead inextricably to the conclusion that Social Security is a "bad" deal. Reform, therefore, is considered politically possible, since the gains from eliminating the system can in part or

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The author is professor of economics, Clemson University, Clemson, S.C. 29631.

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altogether be used to offset the losses imposed on current and future net beneficiaries of the system.

In short, the Social Security system is inefficient, inequitable, and immoral. Indeed, with respect to the unethical nature of the system, we can view past and current net beneficiaries of the system as having exploited the political system to their own advantage.

Considering the extent and severity of the criticism, one must wonder how the system could possibly survive; one would think that it must simply self-destruct. Certainly, few truly doubt that Social Security can survive in its present form.

In this paper, I will consider the conceptual rather than actuarial soundness of various proposals for reforming the Social Security system. Consequently, I will remain largely unconcerned with an issue important in current policy discussion—whether or for how long reforms such as the one recently passed by Congress and signed by the president will reestablish solvency in the Social Security system. Further, I will assume for purposes of argument (if not out of conviction), that most of the criticisms itemized above and documented in detail elsewhere are reasonably accurate. This approach will allow us to focus our attention on searching for the fundamental institutional defect in our political system that has generated the existing Social Security crisis. Once we have identified the institutional defect, reform proposals can be evaluated not in statistical terms, which are always subject to change, but in terms of whether or to what extent the observed defect is remedied.

My basic conclusion is that none of the current reform proposals addresses or resolves the institutional problem that permitted the emergence of the present Social Security system. Therefore, the line of reasoning developed here suggests that current reform proposals are more sedatives than cures for our policy ills, which implies that any of the benefits that might arise from enacting the various reform proposals are likely to be short-lived. Real reform requires constitutional containment of the entire welfare state, not just of the Social Security system. Such a broad-based solution may in the end be impossible, but it is still worth considering.

Finally, my arguments on the source of the current Social Security crisis are admittedly exploratory, reflecting my conviction that available theory fails to adequately explain the political viability of Social Security. I do not wish to deny that Social Security has succeeded partly because of the bloc voting of the elderly; rather, I seek an explanation of why the individuals who do not receive checks and who appear to be net losers from the system continue to support it.

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The Critical Defect of Democracy

Democracy is a practical compromise between an authoritarian rule, in which political power is concentrated in the hands of one person or a few people, and no rule at all. Democracy disperses political and economic power by setting limits on the freedom of each and every person; it thereby diffuses and negates the tendency of each and every person, in the words of Thomas Hobbes, to obtain what he can "for so long as he can keep it."[1] The critical defect of democracy has long been recognized, namely, the less-than-unanimity, simple-majority voting rule conventionally adopted as a means of mitigating or resolving conflicts among competing interests. The central problem with such a voting rule, in the exaggerated but eloquent prose of historian Thomas Babington Macaulay, is that "institutions purely democratic will never be able to restrain a distressed and discontented majority," that in some year of scarcity the majority will "devour all of the seed corn and thus make the next year, a year not of scarcity but of absolute famine."[2]

Contemporary public-choice economists, many of whom are hard at work in the subdiscipline that has come to be known as constitutional economics, have carried Macaulay's concern with the inherent defects of democracy one step further. Arguing from conceptual and practical standpoints, they state that unless private property is constitutionally protected, the wealth of all in a democracy will be subject to usurpation by an endless and varied array of interest groups. Such groups represent minorities who, because of their concentrated interests and the latent political interests of broader majorities, choose to consume from the nation's stock of seed corn to the point that there is a net loss to society.[3] The emerging literature on rent seeking is replete with examples of how interest groups seek special privileges and in the process dissipate their profits, adding to the social loss from their monopoly power.[4] Indeed, in a majoritarian democracy, the ultimate objective of rent seekers is to use government to establish a monopoly position that will generate economic rents. Interest groups can then compete for these rents. A central thesis of Mancur

[1]Thomas Hobbes, *Leviathan*, ed. C. B. MacPherson (Baltimore, Md.: Penguin Books, Inc., 1968), pp. 185–88.

[2]Thomas Babington Macaulay, letter to Henry Stephen Randall, May 23, 1857. The letter is reprinted in Richard B. McKenzie, *Bound to Be Free* (Stanford, Calif.: Hoover Institution Press, 1982), p. xiii.

[3]This theme is more fully developed in McKenzie, chaps. 5–6.

[4]For essays in the emerging literature on rent seeking, see James M. Buchanan, Robert D. Tollison, and Gordon Tullock, eds., *Toward a Theory of the Rent-Seeking Society* (College Station, Tex.: Texas A&M University Press, 1981), especially chaps. 1–3.

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Olson's new book is that political stability may be the seedbed of slower economic growth, because political stability allows larger and a greater number of interest groups to acquire benefits not from production, but from the redistributive power of government.[5]

Following this line of analysis, the defect of democracy springs from the human tendency toward predation. Democracy does little to dampen this inclination and unless properly constrained may intensify it. But democracy shifts the forum for predation from the streets to the halls of Congress. It makes predation legal and to that extent, civilized; and it establishes certain limits on predatory activity. Presumably, the resources tied up in rent seeking and destroyed by inefficient government policies in a democracy are worth less than the resources that would be lost to brute force under anarchy.

The literature on the economics of regulation vividly illustrates the tendency of interest groups to exploit democracy's critical defect.[6] Professions and trades such as law, medicine, and landscaping have secured restrictive licensing. The milk lobby has obtained from the government production restrictions and price supports. And industries such as textiles and motorcycles have secured protective tariffs, quotas, voluntary restrictions, and trigger prices. All of these measures are designed to restrict domestic supplies and increase the profits of the protected industries.

While individually such groups may represent relatively few people, their political power is disproportionately large. This stems from the fact that the per capita benefits to these groups are relatively large, while the costs of the government programs are spread thinly over a much larger number of people. In other words, the benefits are substantial and highly visible, while the costs in terms of higher taxes, higher prices, and reduced supplies are dispersed and largely hidden. The very small costs imposed on each member of the consuming public harmed by the special-interest legislation means that costly political opposition will always be limited, leaving an imbalance in the political power structure that favors the special interests.

When not constrained by constitutional restrictions on the scope, variety, and expense of its programs, democratic government—through

[5]Mancur Olson, *The Rise and Decline of Nations* (New Haven, Conn.: Yale University Press, 1982). This book builds on the theory of group behavior developed by Olson in *The Logic of Collective Action: Public Goods and the Theory of Groups* (Cambridge, Mass.: Harvard University Press, 1965).

[6]See, for examples in this literature, Almarin Phillips, ed., *Promoting Competition in Regulated Markets* (Washington, D.C.: Brookings Institution, 1975); and Paul A. MacAvoy, *The Crisis of the Regulatory Commissions: An Introduction to a Current Issue of Public Policy* (New York: W. W. Norton and Co., 1970).

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special-interest politics—will convert national income into a common-access resource. And as is the case with other common-access resources, the national income will tend to be inefficiently utilized: Government will overexpand and resources will be diverted from their higher valued uses in the private sector. When viewed this way, constitutional constraints can be analyzed in much the same way that controls on the use of other environmental resources are evaluated in environmental economics.

Social Security in a Democracy

There is much to be gained from reading the conventional literature on the political origins of Social Security. Following closely the public-choice theory outlined here, it informs us that the elderly are a very effective voting bloc, inclined to participate in the political process to a much greater extent than younger generations, and to use their political muscle to redistribute income from the working population to themselves. It also suggests that the elderly may be supported in their rent seeking by suppliers of goods and services that are primarily designed for the elderly. These may be as general as hospital care and as specific as Geritol. The literature, however, does not fully explain an apparent contradiction—namely, why the younger working generation, especially the one just entering the work force, does not form an effective political bloc to oppose Social Security. If Social Security is as destructive as its critics claim, the net wealth gained by the younger working generation from abolishing the system would be greater than that lost by the elderly. If that is not the case, then many of the proposed reforms have no hope of ever being adopted, because they presuppose that there will be a net gain from reform. Indeed, for real reform to take place, it must be demonstrated that a mutually beneficial trade can be developed between the younger and older generations—that the older generation's claims on the Social Security system can be bought off with government bonds or claims against future government revenues, leaving some net increase in future income for the young. In understanding the breadth of political support for Social Security, I am not completely satisfied with the explanation that older people have a stronger preference for political participation than the younger generation has. I therefore seek a different perspective for evaluating Social Security.

We can expand our analysis of the widespread political acceptance of Social Security in two ways: (1) by recognizing that Social Security was originally passed as a collection of social welfare programs,

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including unemployment compensation and aid to the disabled and retired, that were logrolled into one system; and (2) by acknowledging that many people below the retirement age (referred to here as "younger" or "young people") have a stake in maintaining the system. Although the aims of the Social Security system may be inherently contradictory in the sense that its welfare and retirement objectives clash, the different groups that support it may make the system politically viable in the same way that the continued prohibitions against the sale of alcoholic beverages in Boone, North Carolina, depend upon a coalition of "bootleggers and Baptists." It seems to me that proposals to separate the welfare and retirement roles of Social Security are designed to divide and conquer the Social Security coalition. It will be interesting to see whether members of the supporting coalition can be outmaneuvered in the political process by opponents of the system who appeal for reform on grounds of efficiency.

The coalition supporting Social Security is probably much broader than commonly thought. Many young people may support the system because they know it relieves them from their obligation to care for elderly members of their families. The support from this sector probably has intensified as the number of workers required to support each Social Security beneficiary has increased. As the ratio of required workers to beneficiaries increases, the potential burden that is placed on younger family members by abolishing Social Security also increases, especially since intrafamily transfers would be from after-tax income. Similarly, as family size decreases, which potentially increases the burden each family member must assume if the system is abandoned, support for the system can be expected to grow among the young. In addition, young people may support the system because they see it as insurance against the erosion of their inheritance as rising living and medical expenses deplete the wealth of their aging parents. Finally, some individuals may join the political coalition of "bootleggers and Baptists" because of the intergenerational transfers of purchasing power involved in the system. How are they likely to act?

When considering democracy as an institutional form designed to promote economic efficiency as well as equity, there is no particular reason to define the relevant voting population in objective terms. Voters can be considered in the abstract. Regardless of how the voting population is defined in the abstract, the theory of public choice tells us that specialized groups will tend to further their private interest with whatever political muscle is at their disposal. If we restrict the relevant voting population to the current generation and the relevant

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national income to what is produced by the current generation, then it follows that all current interest groups will attempt to garner the incomes of all others via the legislative process. This will be true if the demands of individual groups are not so large that they have negative feedback effects on their own incomes.

When the relevant voting population is restricted to the current generation, the impact of shifting distributional questions to the political process becomes reasonably clear. In the context of all generations of voters, the current voting population emerges as a relatively close-knit interest group that has an incentive to redistribute income from future generations to itself. This goal, tempered by a concern for heirs, can be attained by policies that discourage investment and depreciate the nation's capital stock. Such drains on the country's capital stock and shifts of resources away from investment and toward consumption goods offer the current generation an immediate benefit. In this sense, policies that discourage investment, such as Social Security or other welfare programs, illustrate the success past generations have had in diverting consumption goods from our generation and all future generations to themselves.[7]

We should therefore expect a shift in income-allocation decisions from markets to the political process in which the current generation of voters and politicians, whose time horizons may not stretch beyond four or six years, to result in an increase in consumption and a decrease in investment. Actually, since the consumption/investment distinction may more properly be described as the ends of a continuum that runs from immediate gratification to long-term benefits, what is actually suggested by our analysis is that the payoff period for acceptable investment projects will tend to be shortened.

The negative effect of welfare programs such as Social Security on investment may be absolutely necessary to achieve the objective of the generation that enacts it. It has been widely noted that those currently approaching retirement age can obtain increases in their future retirement benefits at the expense of younger workers, who must pay higher future payroll taxes. This process can then be repeated as younger workers reach retirement age. Such "social compacts"

[7]James Buchanan, together with Richard Wagner on the subject of "excessive" deficit spending and with Dwight Lee on the subject of "excessive" tax rates, writes convincingly of the tendency of democratic institutions (specifically the election cycle) to shorten the time horizons of politicians, exploit immobile capital, and discourage investment. See James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Legacy of Lord Keynes* (New York: Academic Press, 1977), and James M. Buchanan and Dwight R. Lee, "Tax Rates and Tax Revenues in Political Equilibrium: Some Simple Analytics," *Economic Inquiry* 20 (July 1982): 344–54.

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must be tenuous at best, since they depend on the bloc voting of retirees and those who may soon retire. Of course, the security of the social compact is enhanced when the ratio of retirees to taxpayers is on the increase. But one must wonder how the relatively small number of people that compose those groups can continue to constitute a winning coalition. It appears to me that the voting coalition must have a broader political base, and that people other than the direct beneficiaries of Social Security must benefit from reductions in investment. I suggest that the members of the general population who are not directly affected by the Social Security system and who place a high value on present consumption goods will lend their political support to the system. They may perceive an improvement in their welfare, because prices of consumer goods will be artificially depressed, at least in the short run.

To the extent that the preceding explanation of the survival of Social Security is correct, it would appear that future voting generations, seeking to increase their consumption, would be inclined to enact policies that would be even more restrictive of investment incentives. The net effect of such behavior, of course, would be a progressive reduction in economic growth. In Lord Macaulay's terms, at some point people may begin to eat the seed corn.

Social Security: The Hole in the Constitutional Dike

The debate over the impact of Social Security on the nation's capital stock has, in my view, been too narrowly focused. Researchers have been concerned with how much Social Security alone has lowered the capital stock from what it would have been. However, Social Security is only one of a wide range of welfare programs that tend to reduce investment incentives. Consequently, it represents only one of the many policy outlets that keep the nation on essentially the same welfare course. Further, it should be recognized that Social Security was one of the first welfare programs and as such may have been the proverbial hole in the country's constitutional dike against government transfers. To the extent that this is the case, a portion of the country's capital stock lost to non-Social Security welfare programs should be attributed to Social Security.

Viewed in these terms, useful reform of Social Security may have to be coordinated with broader efforts to contain the entire welfare state. Containment of Social Security alone may do little or nothing to curtail the basic incentive of the current generation to direct consumption to itself and away from future generations. Any savings derived from curtailing Social Security can be largely lost in the

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expansion of existing transfer programs and in the initiation of new ones. For this reason, successful reform must involve a *constitutional restriction* on the overall size of government and on its power to redistribute income. Such a restriction could entail a rule that ties the transfer budget to either national income or to total government expenditures, which are tied to national income.

Proposed Reforms

Proposed or enacted reforms of the Social Security system tend to fall into two broad categories.[8] The first type of reform seeks a short-run and politically modest objective: to make the Social Security system once again solvent by raising projected taxes, extending coverage, and/or reducing projected benefits. The Reagan administration has sought this type of reform.[9] Specifically, it pushed through Congress a proposal that

- increases the 1984 payroll tax by .3 percentage points (an increase that is a credit against federal income taxes and an indirect means of making use of general revenue) and advances a portion of the increase in the rate of payroll tax scheduled for 1990 to 1988;
- raises the Social Security tax on self-employed persons by one-third;
- extends coverage to new federal workers and employees of non-profit organizations and prohibits withdrawals by state and local governments;
- postpones for six months the cost-of-living increase scheduled for 1984;
- eliminates cost-of-living increases in benefits when the consumer price index rises by less than 3 percent;
- makes Social Security benefits of high-income earners subject to taxation; and
- raises the retirement age for future beneficiaries.

Variations on the theme of restoring short-run solvency to the system are embedded in proposals to change the indexing method used to compute future benefits,[10] shift the entire Social Security tax

[8]A number of the proposed reforms discussed below are sketched in greater detail in Peter J. Ferrara, *Social Security: The Inherent Contradiction* (Washington, D.C.: Cato Institute, 1980), chaps. 10–11.

[9]Social Security Amendments of 1983 (P.L. 98-21; April 20, 1983).

[10]See Ferrara, pp. 314–24.

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burden to general revenue,[11] or increase the employer's contribution to the system.[12]

The second type of reform, advocated most forcefully by Peter Ferrara,[13] entails separating the welfare and retirement functions, now incorporated under the Social Security umbrella, into two programs. Under this type of reform the welfare function would be covered by general revenue, while the retirement function would be addressed more or less as an insurance program. Although the Brookings Institution proposes that Social Security retirement benefits be retained as a governmental function and be related solely to past wages,[14] other reformers propose that the retirement aspect of Social Security be phased out. Charles Hobbs suggests that the "debt" owed to prospective retirees can be converted into government bonds to be given to people in amounts that would yield a retirement income that could be expected from past contributions to the system.[15] Milton Friedman suggests a simpler change, one that guarantees all workers a retirement income equal to what they have been promised under current law, based on their past contributions.[16] James Buchanan proposes that the payroll tax be converted into a required purchase of government Social Security bonds that would carry a rate of interest equal to the higher of the interest rate on government bonds or the rate of growth in Gross National Product.[17] Finally, the Ferrara plan would require that people establish their own retirement accounts with any one of a number of programs approved and monitored by government.[18]

While privatizing the retirement component of Social Security is a step in the right direction, two concerns should be addressed in

[11]Joseph Pechman, Henry Aaron, and Michael Taussig, *Social Security: Perspective for Reform* (Washington, D.C.: Brookings Institution, 1968); see also Ferrara, pp. 324–30.

[12]Arthur B. Laffer and R. David Ranson, "A Proposal for Reforming Social Security," H. C. Wainwright and Co., May 19, 1977; see also Ferrara, pp. 338–40.

[13]Ferrara, chap. 11.

[14]Alicia H. Munnell, *The Future of Social Security* (Washington, D.C.: Brookings Institution, 1977).

[15]Charles D. Hobbs and Stephen L. Powlesland, *Retirement Security Reform: Restructuring the Social Security System* (Concord, Vt.: Institute for Liberty and Community, 1975); see also Ferrara, pp. 340–44.

[16]Wilbur J. Cohen and Milton Friedman, *Social Security: Universal or Selective?* (Washington, D.C.: American Enterprise Institute, 1972); see also Ferrara, pp. 348–50.

[17]James M. Buchanan, "Social Security in a Growing Economy: A Proposal for Radical Reform," *National Tax Journal* 21 (December 1968): 386–95; see also Ferrara, pp. 344–45.

[18]Ferrara, chap. 11.

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reviewing the reform proposals. First, the proposals do nothing to alter the political institutions that permitted Social Security to evolve into the present crisis-ridden system that is the subject of proposals for reform. As noted earlier, a number of suggested reforms propose to divide and conquer the supporting coalition. However, if there are no effective changes in the institutional setting or the level—policy versus constitutional—at which reforms are considered, one must question the probability for success of the reform movement. Any attempt to alter the Social Security system without a corresponding constitutional limit on government spending and taxing powers will be short-lived. Without a limit on transfer spending, Congress could easily abandon, with the switch of a few seats and votes, any Social Security reform package and return to the pre-reform system. Indeed, there would be strong pressures to do so. Hence, all the energy that is used to reform the system will be misspent if it falls short of real constitutional change.

There is nothing that I can detect in the Reagan reform package to prevent future politicians from continuing the practice of promising benefits in excess of projected Social Security taxes, even at the higher tax level imposed by the current Congress. The best we can hope for out of the 1983 legislation is that Congress will hold off any *further* payroll tax increases, at least for the next several years. The legislation has not separated the welfare and retirement aspects of the Social Security program, and there is nothing to prevent Congress from treating the retirement component as a transfer mechanism if the welfare component is placed under general revenues. Indeed, if privatizing the retirement component would generate the benefits attributed to the change, it would pose a real temptation to future politicians interested in redistributing wealth and income. In short, I question whether investment will be significantly spurred by these reforms if the institutional constraints remain the same and if, as a consequence, future tax policies remain basically unchanged.

Second, by clamping down on Social Security, the transfer pressure will not have been abated; only one outlet among a multitude of conceivable outlets will have been closed, and perhaps for only a short time. Without constraints on the transfer capacity of government, the flaws observed may very well emerge somewhere else in the federal budget or regulatory ventures. Hence, the long-run effect of nonconstitutional reform of Social Security could conceivably be negative; all that might be accomplished would be to divert resources from productive purposes to efforts at reform that may not themselves be effective in reducing the costs and inefficiencies of government.

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Conclusion

The purpose of this paper has been to provide a general evaluation of the reform proposals for the Social Security system. As opposed to considering the actuarial mechanics of reform, attention was focused on what are believed to be institutional flaws in the political system—flaws that permit programs such as Social Security to become law. The main criticism leveled at the reform movement is that proposed reforms do not attempt to correct the institutional flaws. Rather, they attempt to change the course of policy, given political institutions. From the constitutional perspective developed in this paper, one must wonder whether the proposed reforms could conceivably accomplish very much in the long run. Real Social Security reform may entail constitutional restrictions on the size of the state, such as those envisioned in the balanced-budget/tax-limitation amendment currently before Congress, or overall restrictions on the size of transfer payments, or increases in the majority required for passage of social legislation. In summary, I must question whether lasting reform of Social Security is possible without a broader constitutional reform.

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"ABSENCE OF LASTING REFORM": A COMMENT

Joseph A. Pechman

Oddly, I agree with Professor McKenzie's conclusion that Social Security will not be altered in any fundamental respect, but—as you might expect—I arrive at it from exactly the opposite direction. Far from believing that the Social Security system is a "fraud," I believe that it is the most effective social program ever devised in this country. In 50 years, the system has accomplished what no other program could ever have done: It has raised the average income of the aged to the average income of the nonaged and it has placed a floor under the income of the elderly. It has given dignity and security to millions of Americans and has revolutionized family life in this country. McKenzie knows these facts, but his animosity to all transfer payment programs is so deep that he cannot bear to face them. So, he laments the continued popularity of the program, while I applaud it.

McKenzie lets us in on a very well known secret. The Social Security system is alive and well. It is supported by both political parties, by conservatives and liberals, and by the aged and the young. The National Commission on Social Security Reform, which consisted of political, business, and labor leaders representing all shades of opinion, opened its report with the following ringing endorsement of the system:

> The members of the National Commission believe that the Congress, in its deliberations on financing proposals, should not alter the fundamental structure of the Social Security program or undermine its fundamental principles. The National Commission considered, but rejected, proposals to make the Social Security program a voluntary one, or to transfer it into a program under which benefits

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The author is director of economic studies at the Brookings Institution, Washington, D.C. 20036.

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> are a product exclusively of the contributions paid, or to convert it into a fully-funded program, or to change it to a program under which benefits are conditioned on the showing of financial need.[1]

McKenzie's explanation of this statement is that it is another example of the "bootleggers and Baptists" again raping the public. At one point he admits that "The coalition supporting Social Security is probably much broader than commonly thought."[2] But he quickly dismisses this support on the ground that the younger generation (which he agrees is part of the supporting coalition) really does not understand that it is being impoverished by the system. McKenzie arrives at this conclusion because he believes that Social Security has reduced saving in this country. Only Martin Feldstein, however, has concluded that Social Security has reduced private saving.[3] All of the other studies—even those undertaken by highly respected conservatives—have found that Feldstein's results cannot be supported by dispassionate analysis of the data.

McKenzie is very familiar with the Brookings Institution's work on Social Security, but he has either not read or chooses to disregard Henry Aaron's 1982 study on the *Economic Effects of Social Security*. After a detailed review of all the available studies, Aaron concludes that "the evidence does not support the position that reductions in social security benefits would be effective in increasing private saving" (p. 52). He goes on to say that if we want to increase national saving, the best way is to eliminate the federal deficit—incidentally, a deficit *not* attributable to Social Security—and that raising Social Security payroll taxes or cutting Social Security benefits is not the best way to achieve that objective.

McKenzie also states that the Social Security tax has reduced labor supply, but again he pays no attention to the numerous competent studies on this subject. The fact is that the effect of the Social Security tax on labor supply of younger workers is slight. There is a difference of opinion about whether Social Security encourages people to retire early, but that is a function of the retirement test and not of the tax used to finance retirement benefits.

I want to return to the theme of the rationale for the Social Security system. In the 1968 book, published by the Brookings Institution,

[1]*Report of the National Commission on Social Security Reform* (Washington, D.C.: U.S. Government Printing Office, January 1983), chap. 2, p. 2.

[2]Richard B. McKenzie, "Social Security: The Absence of Lasting Reform," *Cato Journal* 3 (Fall 1983): 472.

[3]Martin S. Feldstein, "Social Security, Induced Retirement, and Aggregate Capital Accumulation," *Journal of Political Economy* 82 (September/October 1974): 905–26.

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that I coauthored with Henry Aaron and Michael Taussig, *Social Security: Perspectives for Reform,* we concluded that Social Security is an "institutionalized compact between the working and the nonworking generations, a compact that is continually being renewed and strengthened by every amendment to the original Social Security Act" (p. 75). We devoted a complete chapter to explaining the rationale for Social Security.

The system established in the United States is intended to provide a base on which individuals can build an adequate retirement program. In our view, such a system is justified because there is "widespread myopia with respect to retirement needs" (p. 61). McKenzie does not like the use of the term "insurance" to describe this program. But here again, he does not quite use the right terminology. The system has been sold as "social insurance," not "insurance." While I agree with McKenzie that it is at least as much a "tax-transfer system" as it is an insurance system, it is clear that the American people value it as *social* insurance and do not intend to see it modified in any fundamental way.

Having said that, I must hasten to add that I believe that a lot more needs to be done to improve the Social Security system. The report of the 1979 Advisory Council on Social Security, of which I was a member, is a good starting point. That report proposed changes to improve the benefit structure, modify the treatment of working wives so that they would get more out of the system, tax half of Social Security benefits (the 1983 legislation was only a first step, since it applies only to individuals with other incomes of more than $25,000 and married couples with more than $32,000), and many other worthwhile changes. The changes proposed in that report would improve a program that is already operating effectively, McKenzie notwithstanding.

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ALTERNATIVE CONSTRAINTS ON SOCIAL SECURITY

Colin D. Campbell

As a background for my comments, let me start by summarizing the main points made by McKenzie. The paper is about the predatory activities of groups with political power (transferring income from others to themselves through the political process). The Social Security system is viewed as the result of the predatory activities of the current generation in relation to the future generation. The current generation has benefited itself by increasing its consumption at the expense of investment, thus lowering the incomes of future generations. Because predatory activities are inherent in our political institutions, McKenzie doubts that the recent amendments to the Social Security Act will have long-lasting effects, and he is skeptical of most reform proposals. He recommends constitutional restrictions on the size of government or restrictions on the size of total transfer payments.

I believe that McKenzie's approach to understanding the changes that are going on in the Social Security system is enlightening. The economic studies of rent seeking are an important contribution to economics. My comments have to do with the various types of predation in the Social Security system. What is going on is more complicated than the emphasis McKenzie places on consumption and investment. Also, in recent years the Social Security system has had financial difficulties in addition to the problems resulting from predation. These financial difficulties may have had more important effects on the system than McKenzie realizes.

My first comment has to do with who is gaining and who is losing in the Social Security system. McKenzie's analysis is almost entirely in terms of the intergenerational transfer. In his view, the current generation is the predator, and the future generation is the victim.

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The author is Loren M. Berry professor of economics, Dartmouth College, Hanover, N.H. 03755.

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Although the intergenerational transfer has been very large in the past, it is steadily diminishing. This type of transfer occurs only in the start-up phase of a pay-as-you-go social insurance system. In the start-up phase elderly retirees spend only a few years paying taxes into the system, and the tax rates needed to cover the total benefits are low. As a result, the benefits that the first generation receives far exceed the value of the taxes it paid in. For young people today the intergenerational transfer is over. The taxes that many of them pay in will be larger than the value of the benefits they can expect to receive.[1] The current working generation is no longer increasing its consumption at the expense of future generations. Although there are important examples of predation in the Social Security system, McKenzie's use of the intergenerational transfer and his emphasis on consumption and investment are misplaced.

Also, the way the intergenerational transfer has diminished seems to contradict one of McKenzie's main ideas—that predatory activities are determined by the power of political groups. The intergenerational transfer has diminished not because of the realignment of political groups, but because of the nature of a pay-as-you-go social insurance system. You cannot start up such a system without greatly benefiting the first generation. Although the benefits received by the first generation probably explain much of the political support for the system, it does not explain its continued support once the system matures.

In addition to the intergenerational transfer, there are many intragenerational transfers, and there is no tendency for these transfers to diminish as the system matures.[2] Because of the spouse's benefit, there is a substantial transfer of income from single people to married couples and from working wives to nonworking women. Also, because women on the average live longer than men, there is a major income transfer from single males to single females. In addition, because of the lower tax rates paid by the self-employed, there is a transfer of income from employees to the self-employed. Also, because government employees have not been covered in their main occupations but can qualify for the relatively large minimum benefit by working just long enough in a covered job, there is a transfer from nongovernment workers to government workers. Finally, as a result of the work income test, there is a transfer from working elderly from age 65 to

[1]See table 7 in Anthony Pellechio and Gordon Goodfellow, "Individual Gains and Losses from Social Security before and after the 1983 Amendments," *Cato Journal* 3 (Fall 1983): 437.

[2]Ibid., tables 6, 7, and 8.

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70 to nonworking elderly age 65 to 70. I believe these transfers are perfect examples of predation. They reflect the self-interest and political power of the groups benefited. They have little moral or any other kind of justification.

There is another type of intragenerational transfer that has not been widely acknowledged, but is mentioned by Gordon Tullock in his recent book, *Economics of Income Redistribution.*[3] This type of predation may explain the system's broad political support after the start-up phase—a question raised by McKenzie. A basic objective of Social Security is to compel all workers—whether rich or poor—to pay Social Security taxes in return for benefits in their old age. As a result, when workers become too old to work, they will not be a burden to others. From this point of view, the individuals that benefit are those who would have had to support the persons who might have reached old age without any means of support. The individuals that lose out—probably often the less fortunate—are those who are now compelled to pay Social Security taxes that they otherwise would not have had to pay.

In my opinion, McKenzie is correct in stressing the difficulty of getting rid of predatory activities. However, his focus on the intergenerational transfer is too narrow. In the future, the intragenerational transfers will be more important than the intergenerational transfer.

My second comment has to do with the system's financial problems and their effect on predation. The important amendments to the Social Security Act passed in 1977 and 1983 and the other changes made since 1974 are the result of these difficulties. These financial problems are also a reason for most of the proposals for radical reform.

The cause of the system's financial problems is not just the high levels of benefits and taxes resulting from predation. The system's earliest financial crisis was the flaw in the indexing system legislated in 1972. Although the flaw was corrected in the 1977 amendments, it required a radical revision of the benefit formula. An additional source of concern is the decline in the birthrate since 1957 and its effect on the 75-year projections of the cost of the system. It is now predicted that the cost of the Social Security system is going to increase sharply in the next century because of a rise in the ratio of beneficiaries to workers. A third problem—the immediate shortfall in revenues during the past decade—was caused primarily by the decline in the real wage differential, i.e., the more rapid rise in consumer prices than in wages. A pay-as-you-go Social Security system

[3](Boston: Kluwer-Nijhoff Publishing, 1983), pp. 113–14.

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in which benefits are indexed to the consumer price index and revenues are obtained from earmarked taxes on wages soon runs out of funds if prices rise faster than wages. This problem was unexpected. Before the 1970s, wages in the United States almost always rose faster than prices, and the Social Security system was designed on the assumption that this relationship between wages and prices would continue. A fourth problem looming on the horizon is the exploding cost of Medicare. In recent years, the cost of Medicare has been rising much faster than the revenues from its share of the total payroll tax.

McKenzie argues that the only effective way to restrain predatory activities is to put restrictions on either the growth of total government expenditures or on the growth of total transfer payments. I believe the recent financial difficulties have had the same type of effect as McKenzie's proposals would have. They put constraints on the system whatever may be the efforts of the various groups that are attempting to transfer income to themselves through the political process.

The recent cutbacks in the Social Security system are more important than usually realized. The 1983 amendments include two measures that will reduce intragenerational transfers. The coverage of Social Security was extended to newly hired federal government employees and to all employees of nonprofit organizations. This will reduce the transfer of income from nongovernment employees to government employees. In addition, the payroll tax rate paid by the self-employed was raised so that it will be equal to the combined employee-employer rate. This will reduce the transfer of income from employees to the self-employed.

There have been other important cuts in benefits. The 1977 amendments reduced replacement rates—the ratio of the benefit a worker receives upon retirement to his wage just before retirement. For the average earner, for example, the replacement rate was reduced from a peak of 54.5 percent for single persons retiring in 1981 to 42 percent for those retiring in 1988 or later.[4] The 1983 amendments included a six-month delay in the cost-of-living adjustments for benefits, taxes on the benefits of persons with high incomes, a rise in the eligibility age for full retirement benefits to age 67 from age 65 and lower benefits for those who retire early, and the indexation of benefits to either the increase in wages or prices, whichever is lower, depending

[4]U.S. Senate, Committee on Finance, *Staff Data and Materials Related to Social Security Financing*, 97th Cong., 2d sess., Committee Print 97-19, December 1982, p. 49.

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on the condition of the trust funds. In addition, in the 1981 Omnibus Reconciliation Act benefits were reduced for persons entitled to the minimum benefit, beneficiaries with children in college, persons receiving child-care benefits, and persons receiving the lump-sum death benefit.

These reductions in Social Security benefits have been a surprise. The 1983 amendments were considered to be a remarkable piece of legislation because they included lower benefits as well as higher taxes. The conventional wisdom has been that Social Security benefits cannot be reduced. Cuts in benefits were said to be impossible because it would be political suicide for any legislator to vote for them.

I believe that the cutbacks that have been made would not have occurred if the Social Security system had not had financial difficulties, and that these difficulties have affected the system in the same way as would setting limits on the growth of total transfer payments. McKenzie's conclusion that the recent changes will not be long-lasting is probably wrong. Predatory activities can be restrained by economic developments that adversely affect the Social Security system as well as by political limitations on total spending. The recent cutbacks, however, tend to support McKenzie's point of view that restricting the growth of total transfer payments would be an effective way to restrain predatory activities.

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CRITERIA FOR REFORMING SOCIAL SECURITY

David Ranson

There are two views on Social Security reform, both of them ardently held and widespread. One is that the system is not in any fundamental difficulty and needs only piecemeal modification. The other, to which I adhere, is that Social Security is in very bad shape and needs fundamental change. The approach I suggest, an "axiomatic approach," does not assume anything to begin with. It consists of a search for goals, a consideration of goals, and an examination of their consequences. It can lead to surprisingly specific conclusions.

I start with the presumption that all is not well with the Social Security system in spite of the most recent shoring-up that resulted from the work of the Greenspan Commission. Indeed, as Peter J. Ferrara ably demonstrates in a paper just published by my firm,[1] the arrival of one more recession would immediately reopen the wounds. To change the system sufficiently to immunize it from economic change will require much more fundamental reform than policy makers have yet been willing to contemplate.

Popularity and Growth of the Program

Two points need to be considered before developing an axiomatic approach to Social Security reform. First, Social Security is admittedly a very popular program. But that is the case with any Ponzi scheme (and I have always believed that analogy is correct). Ponzi schemes are indeed popular among the early participants, and it is only in the later stages that people get upset. Even when it is backed

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The author is general partner and senior economist, H. C. Wainwright & Co. Economics, Boston, Mass. 02108.

[1]Peter J. Ferrara, "Social Security: The Crisis Draws Closer," *The Political Economy in Perspective*, H. C. Wainwright & Co. Economics, May 9, 1983.

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by government compulsion, I believe that any such pyramid will eventually collapse.

Second, why has the Social Security system grown so much over the decades? My theory is that it is due, in part, to sheer bureaucratic inertia. For example, the superindexing that went into the benefit formula in 1972 is conceded by everyone to have been a technical mistake. Yet it took five years to get it corrected—even in a climate where increasing concern was being expressed about the long-range solvency of the system. During that period, some 5 to 10 percentage points were added to total Social Security expenditures, and we still have that extra spending with us today. The incentives within government are such that no serious attempt was made to reverse the rise in spending.

The Need for Axioms

Debates on Social Security (especially those within a political body like the Greenspan Commission) sound like fights among people who are starting from predetermined positions. The participants are not sharing ideas and modifying their views as they learn more. Moreover, the parameters of discussion take full account of the inertia to which I just referred. The debate takes as a given the system as it exists now and assumes that whatever change is suggested will have to be modest.

In a situation like this (if there is agreement at all), consensus amounts only to a compromise reached through a bargaining process. It is not a consensus in the true sense of the word. Moreover, given the way the activism, the political influence, and the media exposure of the different factions change from year to year, 10 years can go by and the bargain that was reached originally may no longer represent the new power balance at all. So the system lurches from one bargain to another, while no one addresses the deeper problems.

The patch-up job that has been achieved during the past year entailed an adversary process at the end of which all participants seem to be unhappy with the result. How much more divisive, then, is real reform going to be? It seems inconceivable to me that general agreement can be reached on any large issue as long as each constituency argues from inside its own straitjacket of political calculation, relying on coalitions of disparate views to vote down proposals it sees as dangerous to its position. If general agreement can be reached at all, it will have to be based on more than a debate among political groups. In a sense, reform may be premature now, however high the costs of delay, because the constituencies are not yet frightened

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enough to let go. When they do, a common analytical approach will be urgently needed.

Calculations about what is politically "feasible" have their place. In a democracy, they help to guarantee that the views of the electorate as a whole, where leadership ultimately lies, will not be overridden. But I feel there are many circumstances in which the electorate looks to politicians for a kind of specialized leadership. It is easy to lose one's way in the maze of complexity within which the debate over the system is carried on. The leadership needed from elected representatives, then, involves much more than the ability to identify a compromise between opposing factions. It requires a sense of direction based on a reasoned analysis of where and how trouble has arisen in the past.

An approach to problem solving that might make a lot more sense would start from a common basis for agreement rather than from a set of fixed positions that necessarily spell disagreement from the beginning of the negotiations. The approach I suggest could bring the electorate itself into the decision-making process. I think it is possible for us to agree on many points, especially in terms of broad principle. The broader the principles, the more universal the agreement. I will call these principles "axioms," because that term is often used in other fields in the same way that I propose to use it here.

I do not want to add to the confusion by contributing a particular blueprint for reforming Social Security. A set of axioms by itself does not imply one, and there are already plenty of proposals around. But if we have axioms, we can evaluate other people's blueprints and other people's piecemeal modifications if necessary. We get an objective view of whether those plans take us closer to the axioms, the ideals, or further away.

At worst, this approach can stimulate those who are uncomfortable with the axioms I suggest to come up with and defend their own. At best, it can distinguish reform proposals that address deeper problems from those that conceal them or merely patch them up. This approach can draw more people into the thought process, including many who are now deterred by the complexity of the calculations or by the heat of the debate. Working on axioms can also enable progress to be made and conclusions to be drawn in surprisingly specific ways.

Some Suggested Axioms

There are a couple of caveats. The axioms I suggest here are not the only ones that make sense. My purpose will have been met if others choose to add to them. Nor are the consequences listed here

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the only consequences. I can only claim to have begun the process. Nor are all desirable axioms necessarily compatible with one another. However, I think that the axioms I outline are compatible. They should also elicit almost universal agreement from the electorate if that they are clearly explained. Finally, I recommend that we consider axioms without trying to determine the feasibility of applying them. At this stage, that not only would be distracting but also would conflict with the main objective, which is to sketch out areas of common agreement.

The four axioms I propose are as follows.

1. *Economic efficiency.* Efficiency is a technical term dear to economists; a less hallowed term to explain what I mean is *nondistortion.* In recent years, many economists have studied the troubles of the Social Security system. Although their political viewpoints differ, they have brought with them awareness of an issue that was often neglected earlier: A large government program can have powerful effects on business and personal economic decisions, and thereby on the health of the economy. It seems a worthwhile goal, therefore, to move toward a situation in which unnecessary distortions are eliminated, and in which all distortions are minimized.

There are many ways in which government programs can distort the economy. However, I am mainly concerned with the overall drag on economic activity that follows from imposing disincentives on firms to use labor, on workers to earn larger incomes, and on entrepreneurs to start businesses.

In a society where taxation is already severe, it is all the more undesirable to add to the disincentives that already discourage "aboveground" economic activity. A redesigned Social Security system ought to restore, rather than further weaken, incentives to participate in the economy. A system that is redistributive cannot be efficient in this sense. Taxing Peter to pay Paul discourages both from working and eventually undermines the system by weakening its tax base.

There are two ways to discourage production and work effort. One is to charge a fee of so many cents for every dollar that is earned by the worker or paid by the employer. It does not matter for my purpose whether the worker or the employer pays this tax. In either case it is a fee that must be paid to allow the labor market to operate. And when you tax something you do get less of it.

The other way is to enable people to live without working. In its extreme form, such a policy would give a free pension to each person regardless of how much work he did. That does not bestir

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people to work harder; indeed, it removes one of the most basic drives, the incentive to work in order to survive. Social Security has an element of this disincentive in it, too. A person becomes fully insured after his first 10 years of employment. By the time he is old enough to plan for retirement, the length of his employment has little to do with the size of the pension he receives.

2. *Recognition of sunk costs.* One of our greatest political problems is the fate of the many individuals who already receive (and many of whom depend on) Social Security benefits. A powerful constituency opposes benefit cuts outright because it fears establishing a precedent for much larger cuts. On the other hand, it is sometimes argued that reforming the system would necessitate reducing future benefits.

This is untrue. Perhaps continuing the system as presently designed would require benefits to be cut. But the design of a new system has nothing to do with the liabilities that (rightly or wrongly) have been accrued in the past. Even though they have yet to be paid, these claims on the present system are a sunk cost. They have now taken their place in the distribution of wealth. Whether to interfere with this distribution of wealth by repudiating some of these liabilities or to finance them somehow is a political decision. Only if we insist on saddling a redesigned system with the liabilities of the past does this apparent dilemma arise.

In a way, this axiom is an application of the old proverb that two wrongs don't make a right. Sunk costs should not be allowed to influence future decisions.

3. *Depoliticization.* Anxiety about the future, particularly among recipients of benefits, can be traced in part to a feeling of being vulnerable to short-term political forces. Correspondingly, critics of the present system often attribute its overcommitments to pork-barrel politics. Congress frequently amends the Social Security Act in minor ways, and occasionally in major ones. The system ought never to be a political football. Indeed, once established, a properly designed system would be immune to the pressures of politics.

4. *Openness.* A further barrier to reform is that the system is too complicated for the man in the street to come to grips with the problems he hears so much about. A well-designed system would be simple and easily understood by its participants. The complexity of the existing benefit formulas and the sensitivity of the system to future trends in inflation, fertility, and so on, have led to confusion, uncertainty, and cynicism. Younger people doubt they will

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ever see the benefits to which their contributions are theoretically laying claim. Rumors of large unfunded liabilities, although officially disputed, do not die away.

There is no way for the average person to find out the size of the Social Security pension he has earned. He also may be unaware, for example, that the unfunded liabilities now amount (perhaps conservatively) to about $30,000 for each man, woman, and child in the population. This amount of implicit debt dwarfs anything that has ever occurred. Imagine instead a system in which it was exactly known not only how much debt had been accumulated, if any, but also how much of a pension one could expect upon retirement, as well as where the means to pay that pension would come from. Such a system would be more appealing to the average citizen than our current Social Security system.

Financial Soundness and Other Criteria

Conspicuously missing from the above axioms is the requirement that Social Security be self-financing and immune from financial threat. I omit it because it is already implicit. It is hard to imagine how a system constructed to follow these axioms exactly could get into trouble.

The benefit formula would be simple, universally understood, easily calculable, and would provide no route for subsidizing one group at another's expense. Any number of participants could be permitted to opt out without endangering the financial status of the remaining participants. No new unfunded liabilities would accumulate. It would be very difficult, perhaps even impossible, to incur a cash deficit. And such a system would help restore prosperity, because it would impose little or no disincentive to work, produce, save, or start a new business. The likelihood of a crisis would be close to zero. No one would fear losing his benefits, and no one would feel that he was being cheated. The predicament of the present system could not arise.

However restrictive they may be in some dimensions, the axioms I suggest leave open many questions on which reasonable people may differ. The size of a redesigned system in relation to the economy, the types of risk that are covered, the extent to which participation is compulsory, and the extent to which the federal government delegates its own role as insuror are all open issues. Although my own preference is for a private system with maximum freedom of choice, I do not think economists have the prerogative to pronounce on such questions. If agreement could be achieved on the axioms,

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they should be submitted to the electorate. Finally, the axioms should be regarded as ideals to be approached, rather than achieved (although I prefer following them faithfully).

Some Consequences of the Axioms

The four axioms and some of their consequences are outlined in table 1 (at the end of this article). First is the *efficiency* axiom. Suppose we were to design a system that did not subsidize one group at the expense of another and that did not provide disincentives to economic activity. And suppose that we pushed these requirements to the logical extreme. The result would be a program that created a one-to-one link between each dollar contributed and the actuarial benefit (in terms of discounted value) earned by that dollar. That, of course, is a very far-reaching conclusion, one that already would close off many reform proposals. However, I find it an appealing idea that would attract the electorate. The same idea appears in the IRA-type proposals that are being discussed by Ferrara and others.

The efficiency axiom has various other consequences. We would not want a Social Security tax as such at all, although we would still somehow have to pay off the liabilities that have accumulated. We would eliminate any means tests or retirement tests that imposed marginal tax rates on particular groups. Following this axiom would also move the Social Security system closer to market solutions such as privatization. The element of coercion could be reduced. But the axiom does not presume a privatized system. That question belongs to a separate axiom.

Another consequence of having efficiency as a goal is that the government would follow the same set of actuarial formulas that a private insurance system would follow if it were unregulated. Differences in life expectancy, according to an objective criterion, should be reflected in the benefit formulas; any other method is a distortion.

The axiom of *sunk cost* means simply that we should acknowledge the liabilities that have accumulated up to now as a debt of the present, regardless of when they are to be paid off in the future. The accrued cash outflow should be regarded as something we have to deal with. But it is illogical to assume (as many do) that any system we build in the future must be saddled with this burden—perhaps in addition to the burden of being self-financing. One even hears the double fallacy that no future system can be self-financing, because it is too expensive to pay for both burdens.[2]

[2]Harry Ballantyne, chief actuary of the Social Security Administration, letter to the editor, *Wall Street Journal*, May 11, 1983, p. 35.

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The *depoliticization* axiom simply means immunizing the system from short-term political change. It means guaranteeing whatever benefit formula is adopted by issuing bonds as the future benefits are earned. Moreover, those bonds should bear the full faith and credit of the government. They should not be repudiable. The system should also be institutionally isolated to strictly limit the political power of anyone to alter those benefit formulas or to repudiate the debt.

The fourth axiom, *openness,* requires that the system be completely understood by the electorate. Nothing should be hidden. That includes not hiding the accumulated liability, however large it may be and however much damage acknowledging it will do to the reported government deficit. The budgetary practices of the federal government do not recognize the accrual of these liabilities, but they should.

Openness also implies separating all the noninsurance elements from the present system by transferring them to some other program. It can only confuse understanding to keep the insurance and redistributive functions of the program together. Participants should be informed of where they stand in the system. In this situation one axiom assists another, because it is much easier to calculate the standing of an individual when the benefit formula consists of a one-to-one link between sacrifice and reward. A participant could receive a notice once each year, or however often we choose, stating exactly how much he has contributed, exactly how much his pension would be if he were to retire at a given age, and what the pension would be worth if he became disabled today. No one is able to make this calculation under the complex system of today.

Finally, openness implies eliminating arbitrary cutoff points that discriminate capriciously among different people and make it more difficult for each person to plan his affairs. As Paul Craig Roberts has pointed out, the 100,000-percent marginal tax rate that the Greenspan Commission thoughtlessly would have imposed on single (unmarried) Social Security recipients as their outside income reached $20,000 would have introduced much arbitrariness and unpredictability into their financial affairs.[3] There are many arbitrary cutoff points in today's benefit formula that are not consistent with the viewpoint that people should know exactly where they stand.

The axiomatic approach is detailed in table 2 and the following tables (at the end of the article). Table 2 suggests some shorthand terms used in discussing some of the design options in later tables.

[3]Paul Craig Roberts, "Social Security: Myths and Realities," *Cato Journal* 3 (Fall 1983): 399.

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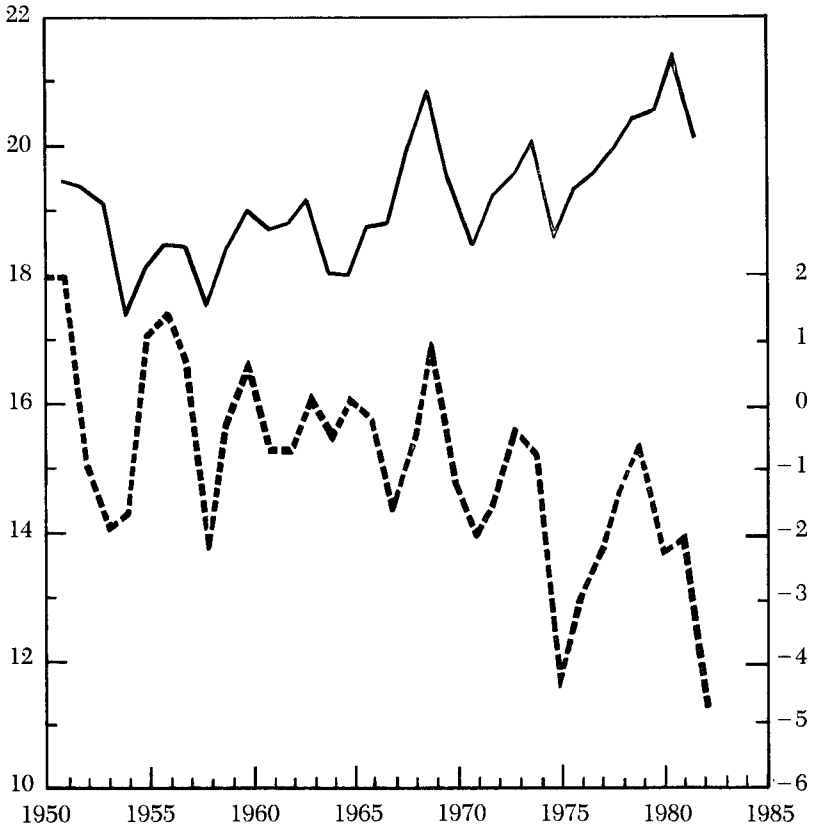
Table 3 applies some of this language to outline the shape of a Social Security system redesigned according to the suggested axioms. Within the scope of this overall design, tables 4 through 6 lay out various options.

Rescuing the System by Tax Increases

Some analysts insist that the answer to a deficit is a tax increase. The following chart casts light on this point. It focuses on the total federal deficit, but the same principle applies to Social Security;

FEDERAL RECEIPTS AND THE BUDGET



Prepared by H. C. Wainwright & Co. Economics

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I hope the implication of my point will be clear. The changes in the budget deficit (the broken line) and in total revenue (the solid line) are compared over the past 30 years. Each amount is measured as a percentage of Gross National Product. Notice the positive correlation; short-term ups and downs in federal revenue correspond to short-term ups and downs in the deficit. No one denies that correlation, and it is easy to explain in terms of the business cycle.

But what is the long-range relationship between federal revenues and federal deficits? Tax rates have been going up, yet the deficit has been growing. This evidence tells us far more than any theory about the power of tax increases to bring deficits toward balance. Tax increases generally do not work as a means of balancing the federal budget. There is no way to prove that the deficit would not have been even greater if tax rates had been held down. However, history shows that tax increases and widening deficits go together. This is the reverse of what some analysts claim. Further efforts to solve the Social Security crisis by imposing higher and higher tax rates, far from narrowing the deficit, may accompany a deficit that continues to widen indefinitely.

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TABLES 1–6

TABLE 1

AXIOMS OF REDESIGN: SOME CONSEQUENCES

Axioms	Consequences
1. *Economic efficiency* The redesigned program should be actuarially sound, and should impose a one-to-one link from future contributions to actuarial value of benefits earned.	Social Security tax as such will be abolished. The retirement test will be eliminated. The system will move closer to market solutions such as privatization. Future contributions will not be tax deductible; benefits thereby earned will not be taxed. Contributions will earn interest that is tax free. Government will follow accepted private-sector formulas for assessing differences in life expectancy according to age, sex, health, and other objective criteria.
2. *Sunk cost* The program would not try to reverse past redistributions of income.	The liabilities and cash flow accrued from the old system will be acknowledged. No balance will be imposed between cash outflow and cash inflow from new contributions. Repayment to contributors of their past Social Security taxes will not be compelled.

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TABLE 1 (cont.)

Axioms	Consequences
3. *Depoliticization* The new system should be immune from short-term political changes.	The new benefit formula will be guaranteed by issuing bonds as future benefits are earned. The system will be isolated so as to severely limit the power of political considerations to alter the benefit formula or to cause default on the benefits. Market prices will be used for all valuation problems: e.g., interest rate paid on contributions; equivalence between annuities and amounts of principal.
4. *Openness* The new system should be utterly simple and understood by the electorate, and nothing should be hidden.	All noninsurance elements will be transferred to other government programs. Participants will be kept informed of the status of their financial stake and the condition of the system as a whole. Liabilities such as future pension claims will not be hidden by not being acknowledged in the unified budget. Arbitrary cutoff points that discriminate capriciously among similar individuals will be avoided.

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TABLE 2

TERMINOLOGY

Retirement Test	A provision of the present Social Security system under which 50 cents of benefit is withheld for each dollar above an exempt amount that a retiree younger than 72 has earned in the labor force.
Retirement insurance	A new retirement scheme that replaces the old Social Security tax and benefits earned thereby with a formula that ties future contributions to benefits on a one-to-one actuarial basis. This scheme may or may not be compulsory. It may be applied to all nonretired adults older than 21 regardless of work status. If the scheme is to be compulsory, people will be allowed to claim exemption, e.g., on grounds of disability or low life expectancy.
Retirement bonds	Nontransferable securities issued, for example, to make explicit or recognize the accrued claims of present workers, to recognize contributions under the new retirement insurance system, and to recognize tax-free interest earned on initial amounts with the passage of time. Guarantee status is the same as that of the recognized indebtedness of the U.S. Treasury. Government is responsible for issuing an annual statement of account to each participant.
Fully insured status	The ability of an individual to prove that his total vested claims from public or private plans are sufficient, given his age at that time, for him to purchase the minimum indexed annuity when he retires.
Retirement annuity	A tax-free indexed annuity issued to a contributor upon his reaching retirement age, in an amount actuarially equivalent to his accumulated retirement bonds.

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TABLE 3

ELEMENTS OF REDESIGN

Individuals already receiving benefits	Payments would continue, with modifications to cost-of-living adjustments (COLA). The retirement test would be abolished. Benefits would not be reduced if an individual chose to work after reaching retirement age. No future contributions to the system would be required.
Claims of individuals not yet retired	A lump-sum claim amount based on past contributions or claims earned thereby would be imputed. Guaranteed retirement bonds in these amounts would be issued.
New arrangements for retirement insurance	Social Security tax would be replaced with a scheme of contributory retirement insurance. Contributions would be made non-tax-deductible. A minimum amount would be established for vested retirement benefits accrued in private or public sources, to confer fully insured status upon individuals.
Financial actions and future role of U.S. government	The trust fund would be abolished. Retirement bonds would be issued to reflect interest accrued on previous holdings. Bonds would be automatically converted to a nontaxable retirement annuity, commencing payment when individual reaches retirement age.

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TABLE 4

DESIGN OPTIONS

FOR INDIVIDUALS ALREADY RECEIVING BENEFITS

Tax status

Benefits may be

1. tax-free,
2. subject to income tax with 50 percent exemption, or
3. subject to income tax without any exemption.

Cost-of-living adjustment

COLA may be

1. left unchanged;
2. made less generous, e.g., by switching to a consumer price index appropriate for the consumption mix of retired people; or
3. withheld until benefit cut of a predetermined percentage has been achieved.

Guarantee status

If benefits are tax-free, retirement bonds equivalent to the actuarial value of the benefit stream could be issued.

FOR INDIVIDUALS NOT YET RETIRED

Computation of claim*

An individual's claim under the new system, and his starting point for accumulating additional pension rights, may equal

1. his claim under the old system;
2. the accumulated amount of his past Social Security taxes, plus interest;
3. his choice of (1) or (2);
4. his claim under the old system less his obligation (or zero, if the latter exceeds the former);
5. his choice of (1) or (2) less his obligation (or zero); or
6. any of the above reduced by a predetermined percentage.

Once his claim under the new system is determined, an individual will receive that amount in retirement bonds.

Privatization

An individual may be

1. required to leave his claim in the custody of the government until he retires, or
2. permitted to withdraw his claim if he invests enough of it in an approved private pension plan to reach fully insured status.

*According to his age and paid Social Security taxes, each worker has at any given time a quantifiable claim on future benefits. The amount depends partly on how the principle insurance amount is indexed to the path of average wages. It is also possible to estimate his obligation, consisting of the discounted present value of the future Social Security taxes he should pay through retirement age, on the basis of extrapolation of his average income.

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TABLE 5

NEW ARRANGEMENTS FOR RETIREMENT INSURANCE

Compulsion

Contributions under the new system may be

1. compulsory for adults over the age of 21 (until they reach fully insured status);
2. compulsory, subject to exemption on grounds of disability, low life expectancy, nonresidence in the United States, and other allowable factors;
3. compulsory only for wage earners; or
4. voluntary.

Management

Contributions

1. must be paid to the federal government in exchange for retirement bonds;
2. may be paid into an approved private pension plan; or
3. must be paid into an approved private pension plan.

Recoverability

Assuming that the system is compulsory, workers

1. may not recover any of their contributions before they reach retirement age;
2. may recover any amount over contributed (i.e., beyond what is necessary for fully insured status); or
3. may borrow back their contributions up to the accrued amount if they can prove need and make arrangements to repay.

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TABLE 6

METHODS OF MEETING THE PREVIOUSLY ACCRUED LIABILITIES

1. **Borrowing.** This method would increase the deficit of the unified budget from $150 to $350 billion per annum.
2. **Temporarily increasing taxation.** This option would become much more appealing when the Social Security tax is replaced by a less burdensome contributory scheme of retirement insurance.
3. **Selling government assets.** The enormous holdings of unused federal land, particularly in the western states, could be sold.
4. **Reducing spending on other programs.**
5. **Repudiating other liabilities.**

Note: Even after scaling down the liabilities inherited under the old system, a cash outflow of $200 billion per annum will have to be met without the help of the Social Security tax. This liability, although it may be considerably smaller than the unfunded liability of the old system, must ultimately be paid out of the national output. General revenues will not be available to pay the debt, because they are already committed. The residual liability must be financed by one of the five methods in this table.

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"CRITERIA FOR REFORMING SOCIAL SECURITY": A COMMENT

A. Haeworth Robertson

Introduction

Although President Reagan has signed a bill that is frequently reported to have laid the Social Security issue to rest, there are still three very important problems with the present system. These can be outlined as follows.

First, the system has financial problems that are relatively small for the next 10 years or so, but that will become enormous after the turn of the century. To restore the balance in income and expenditure solely by tax increases would require that the current employee tax rate of 6.7 percent increase relentlessly for the next 50 years to a level of 14 to 20 percent, matched by the employer.

Second, public confidence in the system has eroded seriously during the past eight years. The elderly fear substantial benefit cuts. The young fear a collapse of the entire system. To regain public confidence, the system must be soundly financed, and it must be perceived as being soundly financed.

Third, the system is out of tune with the times. In the past, the social and economic environment has changed more rapidly than Social Security, and this gap will continue to widen in the future unless significant change is made. The system must be perceived as fair and appropriate if the taxpayers are to continue supporting it. This issue is separate from whether the system is financially sound.

Accordingly, I believe that fundamental change in Social Security is both desirable and inevitable. The longer it is delayed, the more likely it is to be a hastily concocted reaction to a frenetic public outcry for reform instead of a soundly conceived and executed reform that serves the long-range interests of the nation and its citizens as a whole.

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The author was formerly chief actuary, Social Security Administration, and is now managing director of William M. Mercer, Inc., Washington, D.C. 20016.

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How do we bring about a rationally conceived, fundamental change in Social Security? What should the new Social Security look like? We first must acknowledge that there is no single "correct" solution to Social Security's problems. The "proper design" for Social Security depends upon one's individual values and beliefs about social ethics and is therefore not something on which unanimous agreement should be expected among the various interest groups in a nation as large and diverse as the United States.

Setting forth criteria for reforming Social Security is a very critical step in rationalizing Social Security. It is second in importance only to recognizing that there is indeed a need to revise Social Security. I will suggest a few criteria that I believe are important and I will then comment upon the extent to which Ranson has considered them in his presentation.

Criteria for Reform

Cultural Compatibility

The most important criterion for a Social Security system is that it follow a philosophy, or a set of principles, that is consistent with the social and economic environment that we wish to see prevail. A social insurance system is not only a reflection of the social and economic environment that exists when the system is created, it is an important determinant of the environment that will exist in the years ahead.

Many people believe it will be best in the long run if we place increased emphasis on individual thrift and self-reliance and decreased emphasis on the government (a euphemism meaning other taxpayers), but this is, of course, a matter of opinion. According to my view of the world, the nation and its citizens will be best served by a social insurance system that follows certain principles.

- An individual should have as much freedom of choice as possible insofar as that is compatible with the interests of the nation as a whole.
- An individual should be afforded maximum opportunity and incentive to develop and use his abilities throughout his life.
- A government (federal, state, or local) should provide only the benefits that an individual (acting alone or as part of a group of individuals in some form of voluntary pooling or risk-sharing arrangement) cannot provide for himself. In meeting this responsibility, the government should become involved as little as possible, unless the interests of the nation as a whole are affected.

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Our present Social Security has strayed from this philosophy. This variance has already taken its toll in terms of our citizens assuming less responsibility for self and family and depending more and more on government.

It must be borne in mind that a social insurance system, if not properly designed and communicated, can have three deleterious effects. First, it can effectively dictate the retirement age patterns of the nation and thereby encourage earlier retirement even if later retirement may be in the best interests of the nation. Second, it can discourage individual initiative and private saving for retirement, yet fail to provide adequate retirement benefits. Third, it can affect morale by creating unrealistic expectations for retirement. When the expectations are not met, frustration and dissatisfaction will follow. In my opinion, our present Social Security program exhibits these unsatisfactory characteristics in varying degrees.

The first of Ranson's axioms—economic efficiency—touches on the role of Social Security as a determinant of behavior, as a reflection of a culture, and as a determinant of a culture. I do not believe, however, that the axiom emphasizes these important roles sufficiently.

Simplicity

To be successful, a social insurance system must be simple enough for the majority of the population to understand, so that individuals can evaluate the system and then either accept or reject it. A system that is not clear, comprehensible, and communicable cannot endure.

The present Social Security system is so complex that the average person will never know what benefits to expect and hence will never know how much responsibility to assume for himself and his family. This lack of public knowledge will lead to the individual's looking blindly to the government, hat in hand, for whatever benefits "Big Brother" is dispensing. The inevitable results will be erosion of initiative, individuality, and self-respect, as well as the loss of a sense of freedom of choice and control regarding an important aspect of people's lives. Ironically, this system will also lead to the need for an even larger social insurance system, while it reduces the national capacity to finance such a system. Ranson's paper has an axiom called openness, which is virtually the same as my criterion of simplicity. I agree, of course, that even a simple system must be communicated effectively.

Fairness

To be successful, a social insurance system must be fair according to whatever principles of fairness are adopted. There need not be a

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one-to-one correspondence between benefits and taxes. (Ranson advocates such a correspondence in his axiom of economic efficiency.)

To succeed, a social insurance system must not only be fair but be *perceived* as being fair; otherwise taxpayers will not support it. Both the benefits and the supporting taxes must be perceived as being fair. In fact, most measures of fairness are based on comparing benefits and taxes. Social insurance benefits are costly for a mature population in a mature economy. It is difficult enough to maintain taxpayer support for a system perceived as fair. It would be impossible to do so for a system perceived as unfair.

The cost of a pay-as-you-go system is relatively low in the early stages, particularly if the population and economy are growing. The cost of our Social Security system has grown steadily from less than 1 percent of payroll in 1940 to about 14 percent in 1983. It will continue to grow so that an onerous cost will always be a factor in whether the system is acceptable.

The present Social Security system has been represented to the public as being fair in an effort to gain and maintain public support. In reality, the present system is much less fair than it has been represented; it will not withstand much more scrutiny. From the standpoint of public acceptance, fairness may be the most important criterion. Ranson's paper does not have an axiom that deals explicitly with fairness, although his ideas of fairness seem to be woven into all four axioms. I believe that fairness should be a separate axiom.

Flexibility

Social Security is, in effect, a mechanism for dividing the population into two groups: those who work and produce goods and services, and those who are inactive but still share in the results of the production. A flexible system is needed that will permit this separation into active and inactive groups of persons to be self-adjusting with the changing times; that is, changing proportions of old and young, improved health at older ages, longer lifetimes, more women in the paid work force, and so on.

Social Security should also be flexible enough to accommodate changes in the family unit; in particular, it should accommodate the requirements of women moving toward greater independence and equality. The roles of men and women will continue to evolve; they will never again be as stereotyped as they once were. The present Social Security system is relatively inflexible. Furthermore, the public is understandably resistant to any change in benefits they believe they have bought and paid for. Ranson's paper gives no explicit

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recognition to the principle of flexibility, but it is implicit in his four axioms.

Further Reflections on Criteria for Reform

A social insurance system does not exist in a vacuum. It is an integral part of a nation's culture. Accordingly, a social insurance system can satisfy the criteria just stated—or any other set of criteria—and still fail to work. For example, a social insurance system might be designed to satisfy only minimum basic needs, leaving it to the individual to provide the supplemental benefits necessary to maintain a preretirement standard of living. But if there are no reliable institutions through which an individual can save for retirement, the new system will not work. Or governmental policies, such as unfavorable tax policy and various inflationary policies, can thwart the ability of individuals to save effectively and render the new system impotent.

Accordingly, after criteria for reform are designed for the purpose of rationalizing Social Security, all other governmental policies must be revised to be consistent with the reform criteria. Only then will the social and economic environment be free to evolve toward consistency with the desired culture. This adds a new dimension of complexity to the task of restructuring Social Security, but unless this dimension is satisfied, Social Security reform cannot be carried out satisfactorily.

Ranson's paper contains two axioms that I did not include in my list of criteria: recognition of sunk costs and depoliticization. It seem to me that recognition of sunk costs is really a fairness issue, at least to the extent it advocates that present beneficiaries not have their benefits reduced. Ranson's suggestion that the "design of a new system has nothing to do with the liabilities that (rightly or wrongly) have been accrued in the past" is to me perfectly reasonable.[1] However, it raises the question of which accrued benefits should be preserved—those of current recipients, those of persons aged 55 and older, those of persons aged 30 and older, and so on.

Ranson's axiom of depoliticization suggests that Social Security should become immune from politics. I am not so sure this is desirable or, for that matter, even possible. Social Security is a composite of individual equity and social adequacy. We can separate these two elements of the program, and perhaps reduce the politicization some-

[1]David Ranson, "Criteria for Reforming Social Security," *Cato Journal* 3 (Fall 1983):493.

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what, but the social-adequacy feature will of necessity remain a political question. Even the individual-equity feature will remain political, in the sense that the design of the program will be a determinant of our individual and collective behavior. This feature will therefore be an important determinant of social and economic culture.

Conclusion

There is no reason for this country to continue with a social insurance system that is controversial, constantly on the verge of financial collapse, out of phase with the times, and—in my opinion—doomed to ultimate failure. Living with such a system is an unnecessary drain on our collective productivity and psyche. It is eminently more sensible for us to seek a social insurance system that is understood and perceived as fair and reasonable by the majority of the citizens, one that will be a solution to our national problem rather than a part of the problem itself.

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MISDIRECTION OF LABOR AND CAPITAL UNDER SOCIAL SECURITY

Roger W. Garrison

I. Introduction

There can be no doubt that during the four and a half decades of its existence the Social Security program has had a dramatic influence on the allocation of capital and labor resources. The present paper deals with factor-market distortions caused by the program itself and with the potential distortions that may be caused by Social Security reform. As a means of keeping the subject matter manageable, the discussion will be limited to the oldest function of the Social Security program—the provision of retirement income. Limiting the discussion in this way should not be taken to imply that the other functions, which include the provision of disability and health insurance, have had allocational influences less worthy of our attention. The complexity of the Social Security program simply puts a comprehensive treatment out of reach.

The present treatment of the effects of the Social Security program draws heavily on the insights of the Austrian School.[1] Because of its emphasis on the intertemporal allocation of resources, its focus on individuals rather than on aggregate magnitudes, and its attention to the effects of uncertainties, this particular school of thought provides an appropriate framework. The following sections deal with each of these issues as they apply to the Social Security program. Section II

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The author is assistant professor of economics, Auburn University, Auburn, Ala. 36830.

[1]In recent years the term "Austrian School" has come to mean many things. It is intended here to refer to the views and insights best explicated by Ludwig von Mises, F. A. Hayek, and Murray N. Rothbard. See Ludwig von Mises, *Human Action: A Treatise on Economics*, 3d rev. ed. (Chicago: Henry Regnery Company, 1966); F. A. Hayek, *Individualism and Economic Order* (Chicago: University of Chicago Press, 1948); and Murray N. Rothbard, *Man, Economy, and State: A Treatise on Economic Principles*, 2 vols. (Los Angeles: Nash Publishing, 1970).

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distinguishes the Austrian analysis of intertemporal allocation from its neoclassical and classical counterparts. Section III argues the particular appropriateness of the Austrian approach for evaluating not only the Social Security program itself but also the proposed reforms. Because the general effect that Social Security has on the rate of saving is widely understood, the analysis is shifted at this point to focus on the allocational effects of proposed Social Security reform. Section IV calls into question the proposed special tax considerations for retirement savings. Section V argues that a tax-exempt status for retirement savings should be defended on strategic rather than strictly economic grounds. Section VI returns to the main theme of the paper and identifies distortions in capital and labor markets—distortions typically obscured by analyses that focus on aggregate magnitudes, and section VII identifies further distortions associated with uncertainties caused by Social Security. A summary assessment is provided in section VIII.

II. Time Preferences and Capital Productivity

Economists writing in the Austrian tradition deal with intertemporal aspects of resource allocation by focusing on the underlying time preferences of market participants.[2] Analysis based squarely on considerations of time preference differs from standard neoclassical analysis in terms of the respective levels of abstraction: Austrian analysis is one level more abstract than its neoclassical counterpart. And as it turns out, this difference is not inconsequential. The increased level of abstraction allows us to avoid certain analytical errors common in neoclassical theory (even more common in classical theory) and provides a sounder basis for discussions of policy and strategy.

Neoclassical economists take account of the time dimension by focusing on the market for loanable funds. The supply of loanable funds is rightly seen as a reflection of the time preferences of individual savers. The demand for loanable funds is seen as a reflection of the expected rate of return on capital. This view of the demand side of the loanable-funds market, which has some validity under restrictive assumptions,[3] masks more than it reveals. From the Austrian perspective, the demand for loanable funds is just as much a reflection of the time preferences of market participants as the supply is. The current prices of capital goods and of other factors of produc-

[2]Von Mises, pp. 483–90 and passim; also Rothbard, vol. 1, pp. 323–32.

[3]Taking the demand price in the loanable-funds market as a measure of the return on capital assumes away the heterogeneity and specificity of capital goods. Section VI suggests how such simplifying assumptions can lead to erroneous conclusions.

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tion in relation to the expected market value of the consumption goods to be produced by these factors are themselves determined by time preferences. The higher (lower) the time preferences of market participants, the lower (higher) the prices of the factors of production that can yield consumption goods in the relatively remote future. The so-called normal rate of return on capital owes its very existence to this factor-price discounting due to time preference.

Further, the demand for loanable funds is not exhausted by the demand for capital—even if the concept of capital is broadened to include land and human capital. Some individuals borrow funds for the purpose of consumption spending. This component of the demand for loanable funds is clearly rooted in considerations of time preference. In the neoclassical formulation, the demand for consumer loans does not integrate well with the rest of the theory. Therefore, this component of demand is either ignored or netted out of the supply side of the loanable-funds market. In the Austrian formulation, all components of demand—whether registered by investors or by consumers—are reflections of time preferences and can be analyzed on this common basis.

The recognition that time preferences underlie both sides of the market for loanable funds helps avoid a biased view of the trade-offs and choices between consumption and investment spending. The ultimate purpose of all production is consumption. This is a fundamental economic truth that has to be recognized by economists of all stripes. Production is the means, and consumption is the end. Accordingly, the activity of production cannot be considered more important or more valuable or more virtuous than the ultimate consumption that this production makes possible. The demand for future consumption creates a demand for present investment. The interaction of supply and demand in the market for loanable funds (and in other intertemporal markets) will determine the particular terms of trade between present and future consumption. The intertemporal terms of trade are summarily expressed by the rate of interest. The market rate of interest is simply the rate at which the production activities in the economy are most closely coordinated with the preferred time pattern of consumption activities.

With this view of the relationship between production and consumption, the Austrian economist is not inclined to favor a particularly high rate of return on capital or otherwise to encourage the activity of production over consumption. The only rate of return on capital and (more broadly speaking) the only rate of interest that is consistent with the efficient allocation of resources is the market

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rate—the one rate that can emerge without the favor or encouragement of the economist.

The common view that policy should favor investment and capital formation has its roots in the writings of the classical economists, particularly Adam Smith, who distinguished between what he called productive and nonproductive labor.[4] Nonproductive labor is labor that immediately yields consumption services of some kind. Productive labor is labor that adds to the accumulation of capital. There is no problem with categorizing labor in this way as long as it is realized that the definitions of the two categories are purely stipulative. But "productive" and "nonproductive" are value-laden terms. It is too easy to fall into the trap of believing that productive labor is inherently or necessarily more valuable than nonproductive labor and that the former should be encouraged at the expense of the latter.

Such beliefs would certainly be in error. Both categories of labor are aimed at making consumption possible. The only substantive difference is the timing of the consumption activity in relation to the employment of the labor. Nonproductive labor permits immediate consumption; productive labor permits consumption in the future. Left to its own devices, the market will divide labor into the productive and nonproductive categories in such a way that the value of present consumption and the *discounted* value of future consumption are equal at the margin. There is no basis for judging this result to be less than optimal or for recommending policies that would bias the market outcome in favor of future consumption.

In neoclassical theory, the classical distinction between the two categories of labor is dropped, but a potential bias in favor of future consumption is maintained in the treatment of capital. It is easy to fall into the trap of believing that capital is inherently productive and that capital has a positive real rate of return simply by virtue of being capital. There is the temptation to believe that policies should be pursued that will increase the real rate of return on capital or increase the level of savings so as to take fuller advantage of a given rate of return. Such traps and temptations are a result of the failure to identify the source of the productivity of capital.[5] Accumulation of capital permits future consumption. Because of time preferences, the

[4]Adam Smith, *The Wealth of Nations,* Modern Library edition (New York: Random House, Inc., 1937), pp. 314–32.

[5]Exposing the fallacies of the productivity theories is one of the accomplishments of the Austrian School. But one of the earliest and clearest treatments of this issue is found in Frank A. Fetter, "Interest Theories, Old and New," *American Economic Review* 4 (March 1914), reprinted in Fetter, *Capital, Interest, and Rent* (Kansas City: Sheed, Andrews, and McMeel, Inc., 1977), pp. 226–55.

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value of the capital is discounted with respect to the future consumption activities that the capital makes possible. The higher spot value of the future consumption activities in relation to the value of the corresponding capital may be misleadingly attributed to the capital itself, and accordingly capital may be seen as being productive in the value-laden sense.

III. Pro- and Anti-Accumulation Biases

If our current Social Security program were based on the classical vision of the economy, it might well have been designed to encourage an artificially high rate of capital accumulation. Had neoclassical theory served as the basis for the design of the program, a pro-accumulation bias might still have been present. But the Social Security program was designed at the same time that the Keynesian vision was beginning to have its effect on policy formulation. Whether or not it was consciously based on Keynesian theory, this program—along with many other Keynesian policies that were being implemented during the same period—had a strong anti-accumulation bias. By providing retirement income on a pay-as-you-go basis, the Social Security program discourages saving, which of course is the prerequisite for capital accumulation.

Fortunately, this anti-accumulation bias is now recognized by practically all economists who deal with the Social Security issue. Unfortunately, the Social Security reforms being proposed contain biases of their own. Patchwork reforms, such as those recently enacted by the present administration, accept the anti-accumulation bias in the present system and seek only to stave off the day when the inherent problems will have to be dealt with in a more serious manner. Fundamental reforms, such as those discussed and proposed by Peter Ferrara,[6] tend to go beyond the elimination of the anti-accumulation bias and establish a pro-accumulation bias instead. As suggested above, this overreaction may be the result of the biases in classical and to a lesser extent neoclassical theory. Austrian theory, which focuses directly on time preferences as they affect the intertemporal choices of market participants, invites neither an anti-accumulation nor a pro-accumulation bias. It is this unbiasedness that makes Austrian theory particularly suitable for criticizing both the Social Security program and the proposed reforms.

It is not difficult to identify the general anti-accumulation bias in the present Social Security program. Nor is it necessary to dwell for

[6]Peter J. Ferrara, *Social Security: The Inherent Contradiction* (San Francisco: Cato Institute, 1980).

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long on this particular perversity. The bias is becoming more and more obvious as the program matures. Social Security withholdings, coupled with the employer's contribution, create the illusion of savings from the perspective of the individual taxpayer. The resulting false sense of security virtually ensures that individuals will not engage in as much genuine saving as they would have in the absence of the program. (Also, their disposable incomes, having been reduced by the lion's share of both the employee's and the employer's contribution, may not permit much genuine savings.) The pay-as-you-go feature of Social Security ensures that what appears to be savings from the individual perspective is in fact not savings for the economy as a whole. This absence of savings, of course, means an absence of resources with which investments can be undertaken and capital can be accumulated—hence the anti-accumulation bias.

Those who favor fundamental reform of Social Security are acutely aware of this anti-accumulation bias and of the need to eliminate it. The most straightforward means of unbiasing the system is to bring about a transition from the coercive, government-directed, pay-as-you-go program to a voluntary, market-directed, fully funded system. (If this transition were to be made, the resulting solution would constitute a "system" only in the sense that the market mechanisms that facilitate the provision of any category of goods or services constitute a "system.") But many reformers want to go a step beyond this transition. They want to give special tax considerations to all funds that are saved for retirement purposes and to interest income that is earned on those funds.[7] This extra step (apart from the strategic considerations to be considered below) has little to recommend it. If actually adopted, reforms of this sort would induce a pro-accumulation bias with the potential to create distortions that would rival the distortions created by the present system.

IV. The Economics of Tax-Exempt Retirement Savings

Most proposals for fundamental reform of the Social Security program include the provision that the funds saved privately for the purpose of retirement, along with interest earnings that accrue to those funds, be given a tax-exempt status. This provision for tax-exempt retirement savings may turn out to be a desirable feature of Social Security reform. Indeed, it may turn out to be a necessary feature—given the current plight of the existing program. But if so,

[7]A number of specific reform proposals are described in Ferrara, pp. 311–50.

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the desirability or necessity of this feature will have to be based on strategic considerations and not on considerations of economic efficiency. Thus, the arguments below that such a tax provision cannot be based on sound economic reasoning are followed by a discussion of the strategic advantages (and disadvantages) of retaining this provision in reform proposals.

If a tax-exempt status for retirement savings could be taken to imply that the total amount of taxes collected by the government would be reduced by the tax revenues that would otherwise have been generated by these savings, the analysis would be more favorable to the tax exemption. Undoubtedly, gains associated with a total decrease in the tax take would more than offset the efficiency losses associated with the particular way in which the tax is taken. But the assumption that total tax revenues would be allowed to fall as a fortuitous result of Social Security reform is naive and unwarranted. It is more reasonable to assume that revenue losses to the government would be made up soon, if not immediately, by raising tax rates elsewhere. The most likely target of a compensating tax hike would be wages and salaries *not* used for purposes of providing a retirement income. If the total amount of taxes collected remains constant, the analysis must focus exclusively on the effects of the particular way in which they are collected. Adopting this perspective causes the analysis to turn against the tax exemption.

With the assumption of a constant tax take, the popular arguments in favor of tax-exempt retirement funds begin to lose their appeal. The argument is made, for instance, that individuals should receive the "full value" of the returns to investment made possible by the retirement funds.[8] But wage and salary earners who use their entire incomes to meet current expenses (or who simply choose not to save now for their retirement years) do not receive the "full value" of their labor. And if the tax rate on this category of income is increased so as to maintain the level of tax revenues, the discrepancy between the full value and the value received will be even greater. Karl Marx believed that labor income is inherently more meritorious than interest income. This belief, of course, is in error, but so is the converse. Taxes cause both laborers and savers to receive less than the full value of the production that they make possible, but there is no sound economic basis for increasing the value discrepancy for one category of income in order to decrease it for the other.

The case for the special tax considerations is further weakened by the fact that savings for purposes of retirement are to be treated

[8]Ferrara, p. 381.

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differently from savings for other purposes. This differential tax treatment based on the particular purpose of savings has no basis in economic theory of any kind.[9] Should a 60-year-old individual who commits his savings to a retirement account be taxed at a different rate than a 25-year-old who is willing to have his savings tied up for 20 years (but not longer)? Recasting the distinction in terms of the duration of the savings commitment does not make it any more palatable. There is nothing inherently meritorious about making a 20-year savings commitment instead of a 5-year commitment. The market will see to it that interest is paid during the full duration of the commitment, whether long or short. And if the market has a special urgency for long-term funds over short-term funds or vice versa, the term structure of interest rates, determined by the forces of supply and demand in the loan market, will fully reflect both the direction and the intensity of the urgency. There is simply no need in this case for any special tax considerations.

The demonstration that neither the purpose-based distinction nor the term-based distinction finds any support in economic theory may cause some reformers to suggest that all savings be tax exempt, whatever the purpose and whatever the duration of the savings commitment. This modification would certainly eliminate the groundless purpose-based distinction incorporated in many proposals for Social Security reform. (And again, if such a tax exemption could be taken to imply a lower total tax take, there would be much to recommend it.) But to institute an exemption for all savings is simply to transform the income tax into a consumption tax. Those who actually believe that a consumption tax is to be preferred to an income tax should advance arguments that directly support this belief. Ultimately, the issue of which magnitude (income or consumption spending) is the more appropriate tax base cannot be resolved by appealing to economic theory. If one of these two possible tax bases is taken to be the appropriate one, then adopting the other will be seen as a source of economic distortions. The use of either tax base leads to economic distortions in relation to a third alternative in which both savings and consumption spending are tax exempt. And there are no theoretical grounds for preferring the distortions associated with one tax base over those associated with the other.

Finally, there may be a belief lying just below the surface of the arguments in favor of tax-exempt retirement savings that a

[9]Ferrara minimizes the administrative difficulties in establishing the tax status of various kinds of savings accounts, but he fails to make a theoretically sound case for the purpose-based distinction. See Ferrara, p. 358.

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pro-accumulation bias is needed to help make up for the anti-accumulation bias the economy has suffered under Social Security. This belief, of course, is unfounded. It requires such a holistic view of society as to transcend both time and the individuals that make up the society. It is as if there were a goal of having some definite stock of capital at some definite date in the distant future. The economy is running behind in its progress toward that goal because of the Social Security program. Therefore, a pro-accumulation bias is needed so that the economy can make up for lost time. Surely to plainly state this belief is to discredit it. Nearly 40 years of an anti-accumulation bias can in no meaningful sense be undone by 40 years (or an infinity) of pro-accumulation bias. When the preferences of different individuals whose lives span different periods of time are appropriately taken into account, the perverse effects of the anti- and then pro-accumulation biases are seen to be compounding rather than counteracting.

Arguments based on this holistic view of society can be modified so as to apply only to the transition phase—the period of time during which Social Security is being phased out and private retirement funds are being accumulated. The one or two generations who work during this transition period must bear a double burden. They must make good on the existing obligations to which the Social Security program is committed and at the same time provide in full for their own retirement. The pro-accumulation bias created by special tax considerations may be needed to stimulate a rate of saving sufficiently high to serve both ends simultaneously. (This view implies that the government engages in heavy borrowing during the transition phase in order to pay Social Security recipients.) But if the purpose of the pro-accumulation bias is to "get us over the hump," the special tax considerations should be proposed as an interim feature of Social Security reform.

Looking behind the supply-and-demand analysis of the loan market and focusing directly on the time preferences of individuals clearly reveals the perversities of the pro-accumulation bias. As Ferrara makes clear, the tax exemptions advocated by him and other reformers would greatly increase the rate of saving. Workers earning modest incomes may have the incentive to save a million dollars or more during their working years.[10] It is difficult to believe that the true time preferences of such workers are consistent with either postponing this much consumption activity to the period beyond the 65th birthday or bequeathing a million dollars to their children. The

[10]Ferrara, pp. 141–48.

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extreme future orientation of consumption activity is bound to be inferior (in the eyes of the modest-income earner) to an orientation that would have allowed for more consumption activity during the working years. The pro-accumulation bias causes workers to choose otherwise-inferior future consumption over present consumption. The extent of this inferiority constitutes the real costs of the pro-accumulation bias. And there are no economic gains to offset these costs.

V. The Strategy of Tax Exemptions

Economic analysis of the proposed Social Security reforms identifies a pro-accumulation bias in the tax-related features of the proposals. Such analysis argues against a tax exemption for retirement funds—a position that runs counter to the very spirit of Social Security reform. If economic efficiency, narrowly conceived, were the sole criterion for judging reform proposals, the spirit would simply have to yield. But reformers cannot allow themselves to be guided by considerations of economic efficiency alone. The current entrenchment of the Social Security program—an entrenchment that is itself in no way based on sound economic reasoning—requires that strategic considerations play a large role in Social Security reform. Two strategic arguments can be offered in favor of a tax exemption for retirement funds. Although both arguments identify perversities that partially offset the strategic gains, it is likely that the net strategic gains will outweigh the efficiency losses.

Ferrara proposes that current participants in the Social Security program who are under 40 years of age be allowed to opt out of the program.[11] Opting out would mean that the worker would pay no more Social Security taxes and would receive no retirement benefits. But it would also require the worker to write off all the Social Security taxes already paid as a complete loss. While the opting-out provision would be gleefully welcomed by the workers who are already aware of the program's fraudulence and bankruptcy, it would be a bombshell for those who are unaware. It would require that these workers suddenly be made aware of the true nature of the program and of the tremendous costs that the program has imposed upon them. This aspect of the Ferrara proposal may make it politically unattractive. As argued below, the tax exemption for retirement savings, which is an integral part of the Ferrara reform proposal, may by itself be a means of achieving the goals of the proposal. As usual, the increased political feasibility of this alternative strategy comes at a cost.

[11]Ferrara, p. 377.

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Tax-exempt individual retirement accounts (IRAs) and Keogh accounts, which are currently available to retirement-conscious savers, are likely to result in a de facto but only partial opting out. These accounts may constitute a de facto opting out simply because the Social Security program cannot possibly make good on all present promises. It is most likely to renege in the cases in which individuals have made alternative provisions for their own retirement, such as by accumulating funds in an IRA or Keogh account. (A movement in this direction is already under way. The recent reforms make half of an individual's Social Security benefits subject to federal income tax when total income, which includes withdrawals from IRAs and Keogh accounts, exceeds a certain level. It is not difficult to predict that there will be a sequence of reforms in which the "half" is changed to "all," in which a penalty is instituted whereby the retiree forgoes one dollar of Social Security benefits for every two dollars withdrawn from private retirement accounts, and finally in which all retirees who have deposits in such accounts above a certain amount are ineligible for any Social Security benefits.) The opting-out is only partial because it affects only the benefit side of the program. The worker cannot opt out of paying into Social Security for the remainder of his working life.

The opting-out plan suggested by Ferrara makes a distinction between workers under age 40 and workers 40 years of age and older. The partial and de facto opting-out, suggested above as a likely eventuality, makes the distinction between workers who are currently sensitized to the fraudulence and bankruptcy of the Social Security program and are farsighted enough to provide for their own retirement and workers who are now oblivious to the true nature of Social Security. In effect, the tax-exempt IRA and Keogh plans will encourage prudent and farsighted individuals to save for retirement and thereby release Social Security funds that can then pay retirement benefits to imprudent and shortsighted individuals. To the extent that taxpayers foresee the government's selective reneging, there may be a dilemma for those who are now deciding whether or not to begin depositing their retirement savings in IRA or Keogh accounts. But apart from such gaming considerations, special tax treatment for such accounts will ensure that the costs of Social Security reform are borne by those who have the clearest understanding of why reform is so necessary. A tax exemption that leads to these results cannot be defended on grounds of economic efficiency. It certainly cannot be defended on equity grounds. (It should be pointed out that *predicting* that the government will renege on its promises does not imply an *endorsement* of such dishonest policies.) But at

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this late date, considerations of strategy may be overriding. Although the tax exemption is likely to result in an inefficient and inequitable resolution of the current Social Security crisis, it may be the only way to ensure that the eventual and inevitable reneging by the government does not result in an even greater crisis.

A second argument favoring the tax exemption on strategic grounds can be based on broader political considerations. A tax exemption for retirement savings—or for anything else—reduces the size of the tax base. It causes the government to increase the tax rate on activities that are not tax exempt, so as to maintain constant tax revenues. The rate increase has to be more than proportional to the initial shrinkage of the base, to compensate for tax-induced quantity adjustments in market activity; and the rate increase has to be greater still if government revenues are to grow. In short, tax exemptions concentrate and magnify the forces of tax opposition. As the number of tax exemptions and tax credits grows, the assumption that the total tax revenues can and will remain the same as before becomes more and more untenable. A small tax base with high tax rates is likely to give rise to a politically effective movement aimed at reducing the amount of taxes collected. While the tax-induced political process that may bring about a reduction in taxes is fraught with inefficiencies and inequities, the result may be preferable on both efficiency and equity grounds. It should be noted that these considerations of strategy have implications that transcend Social Security reform. They argue against broadening the tax base as the current supporters of the flat tax would have it, and they favor a tax exemption for retirement savings, for all other savings, and for practically anything else.

VI. Distortions Obscured by Aggregates

The Austrian School, because of its direct focus on the issue of individual time preferences, provides a sound basis for assessing the intertemporal biases of both the Social Security program and proposed reforms. Another feature of Austrian theory—its tendency to theorize at lower levels of aggregation in relation to classical and neoclassical theory—provides further insights into the misdirection of labor and capital brought about by Social Security.[12] These insights can best be put in context by reviewing the controversy about the effects of Social Security on the rate of saving.

[12]The advantages of theorizing in terms of individuals instead of marketwide aggregates are emphasized by the articles collected in Hayek, *Individualism and Economic Order*.

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Martin Feldstein argues that the Social Security program tends to decrease the rate of saving.[13] The retirement income provided by Social Security on a pay-as-you-go basis reduces the incentives for individuals to fund their own retirement income through genuine saving. The government's promise to pay retirement is a good substitute—from the perspective of some individuals—for financial assets capable of yielding a similar income. This asset-substitution effect, as it has come to be called, is suggested by the most straightforward application of standard price theory.

Alicia H. Munnell has argued that some features of Social Security may actually stimulate the rate of saving.[14] Social Security provides an opportunity for early retirement but does not by itself provide a level of retirement income that would make early retirement attractive. Individuals who view the program in this way have an incentive to save more during the years that they remain in the labor force in order to be able to pad their retirement incomes. This so-called retirement effect, which is a theoretical possibility, is directly analogous to the income effect in standard price theory.

As is often the case in the application of standard price theory, two possible effects are identified and are shown to work in opposite directions. Social Security gives rise to an asset-substitution effect that decreases the rate of saving and simultaneously gives rise to a retirement effect that increases the rate of saving. The net effect on the rate of saving becomes an empirical question that must be answered by employing econometric techniques to measure the relative strengths of the two effects. It may turn out, of course, that the two effects are equally strong and Social Security is seen as having no effect at all on the rate of saving. In his treatment of this issue, Ferrara steers clear of the thorny empirical issues and offers instead a number of plausible reasons for believing that the substitution effect greatly outweighs the income effect.[15]

In the context of an analysis focused on the aggregate concept of saving, Ferrara's arguments and conclusions are satisfying. But if saving is disaggregated into its many manifestations, it becomes apparent that the two effects—even if they work in opposite directions, broadly speaking—do not cancel one another out. The very notion of a net effect is misleading. Each effect gives rise to its own

[13]Martin Feldstein, "Toward a Reform of Social Security," *The Public Interest* (Summer 1975), pp. 82–83.

[14]Alicia H. Munnell, "The Impact of Social Security on Personal Savings," *National Tax Journal* 27 (December 1974): 553–67.

[15]Ferrara, pp. 89 ff.

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distortions of each individual's consumption pattern. The corresponding distortions in labor and capital markets are in no way offsetting. In an assessment of the inefficiencies of Social Security, these two effects should be added, not subtracted, regardless of what the "general direction" of each effect is determined to be. The correctness of combining the two effects in this manner should become apparent when the level of aggregation is reduced.

Consider two workers, Homer and Melvin, each reacting to the Social Security program in a different way. Homer is content with the retirement income that his government has promised him. Choosing to save very little of his after-tax income, he spends almost all of his income on consumption goods. Melvin, faced with the same opportunities, chooses to spend less on consumption goods during his working years. This choice allows him to retire early and enjoy a relatively high level of income consisting of Social Security payments plus the yield from his accumulated savings. Homer and Melvin have adopted consumption patterns that are different from those they would have adopted in the absence of the Social Security program. These altered consumption patterns give rise to corresponding alterations in the allocation of capital and labor. During the working years, labor and capital are allocated away from the production of the consumer goods that Melvin would have purchased and toward the production of consumer goods of the type purchased by Homer. After the two men retire, labor and capital are allocated away from the production of goods that Homer could have purchased had he provided for his own retirement and toward the production of goods of the type purchased by Melvin. These sequential effects on factor markets will cancel each other out only in the unlikely event that the particular goods forgone by Melvin (Homer) and purchased by Homer (Melvin) are the very same goods. This coincidence would be unlikely for any two individuals—but it is all the more unlikely for two individuals with such radically different time preferences.

Seasoned neoclassical price theorists are comfortable with the assumption of "homothetic indifference curves," which is a formal way of assuming the unlikely coincidence just mentioned. Making this assumption allows neoclassical analysis to ignore the particular manifestations of savings (the embodiment of savings in individual capital goods of all sorts) and to focus on savings as a single magnitude. Austrian analysis highlights the very differences that neoclassical analysis obscures. And by its doing so, the practice of treating the difference between the substitution effect and the income effect (in the context of Social Security or in any other context) as a net magnitude is called into question. The "net effect" obscures and

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understates what is more accurately viewed as a compounding of effects.

The Austrian view is reinforced by an assessment of the effects of Social Security on economic welfare. Both Homer and Melvin are worse off under Social Security than if they had been allowed to provide fully for their own retirement years. This conclusion is firmly established by Ferrara. The reduction in the welfare of both workers takes the form of alterations in their patterns of consumption spending and hence alters the particular manifestations of their savings. Any analysis that focuses on the issue of savings should seek to identify the harm done to both workers and should not suggest or imply that the harm done to one is in any way offset by the harm done to the other.

VII. Distortions Induced by Uncertainties

Compounding the general anti-accumulation bias of Social Security and the misdirection of the capital that is accumulated are further distortions in markets for capital goods—distortions associated with the uncertainties that surround the future of the Social Security program itself. Distortions identified by focusing directly on the time preferences of workers and distortions identified by adopting a less aggregative framework of analysis would characterize the Social Security program even if it were set up as a *sustainable* pay-as-you-go retirement program. But of course, the system as it now exists is not sustainable. Uncertainties about when it will collapse or about how and when it will be changed in order to stave off the collapse have their own effects on the current allocation of resources.

The general nature of these further distortions is most easily seen if it is assumed that the government makes good on its current promises for as long as it possibly can (by raising Social Security taxes and drawing from general revenues). It is further assumed that when the threat of a tax revolt becomes imminent and the prospects of continuing Social Security payments become dim, the Social Security system is allowed to collapse. Retirement incomes then fall to a small fraction of their previous level and consumption spending undergoes a corresponding change. Even if this collapse is predicted to be the eventual fate of the Social Security program, the uncertainty about the timing of the collapse would adversely affect markets for capital goods. Capital must be embodied in particular kinds of capital goods that produce particular kinds of consumption goods. But what particular kinds of consumption goods will be in demand depends to a large extent on the incomes of the different categories of consumers.

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A sharp drop in retirement incomes will cause a restructuring of consumer demand and will require a corresponding change in the structure of capital goods. Unless both the collapse itself and the exact timing of the collapse are fully anticipated, the employment of capital both before and after the collapse will be less than optimal. Before the collapse, there will be a hesitancy to invest in the kinds of capital goods that produce the consumer goods and services that are demanded primarily by retirees. After the collapse, these kinds of capital goods will be in excess supply. Building up retirement communities, for instance, involves the kinds of capital that would be affected in this way. Capital withheld from such projects because of the anticipated collapse may be committed to other lines of production or may be held in liquid form. Capital that suffers a loss of value because of the collapse may be put to second-best uses or abandoned altogether. In any case, the uncertainty about the timing of the collapse means that the level and pattern of production under the assumptions set forth above are inferior to what they could otherwise be.

Distortions in the market for capital goods are reflected by the market for labor. There will be an increased demand for some kinds of labor and a decreased demand for others, depending upon the specific relationship between the particular kind of labor and the capital goods with which it is used. Whether the relationship is one of complementarity or one of substitutability, the efficiency with which labor resources are utilized will be diminished by the uncertainties created by Social Security. These distortions are compounded by considerations on the supply side of the labor market. Workers will be differentially aware of the coming collapse of the Social Security program. Those who are aware will have to make a judgment about the timing of the collapse: They will have to guess whether they will be the last generation to receive the promised benefits or the first generation to be deprived of them. The assessment that each worker makes will affect that worker's willingness to supply his services in the labor market. Some workers may retire early to take advantage of the twilight years of the Social Security program; others may extend their working years so as to hedge against an early Social Security collapse.

The assumption that Social Security benefits will be paid as promised until the program completely collapses was invoked for convenience of exposition. In all likelihood the program will undergo a seemingly unending sequence of modifications of one kind or another. Dropping the simplifying assumption complicates the analysis but does not alter the conclusion in any substantial way. There will be

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uncertainties about the timing of each modification and about what, in particular, the modifications will be and how they will affect individual workers and businessmen. It is not difficult to see that both labor and capital will be used with diminished efficiency in an atmosphere of such economic uncertainties.

VIII. A Summary Assessment

Econometric techniques may permit the detection of the various effects of Social Security on broadly defined aggregates such as "savings" and "the employment of labor." But when detected, such effects are likely to represent a gross understatement of the distortions caused by Social Security. Even the finding of "no effect" on these aggregate magnitudes would be no cause for comfort. Analysis that focuses on the *individuals* in the economy rather than the aggregate magnitudes reveals possibilities for distortions that are obscured by the aggregate statistics. Distortions associated with the worker's uncertain prediction of the collapse of Social Security and with his inability to tailor the pattern of consumption to his true time preferences, as well as the distortions associated with the businessman's diminished ability to forecast the pattern of future consumption demand, are impractical if not impossible to measure. Nonetheless, such distortions are real and should be taken into account in assessing the costs of the Social Security program. Politically viable reforms may involve distortions of their own, such as the distortions associated with the tax-exempt status of retirement savings. These distortions, though lamentable, may be an unavoidable feature of any successful strategy designed to hasten the end of the coercive and inefficient Social Security program.

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MISDIRECTION OF LABOR AND CAPITAL UNDER SOCIAL SECURITY": A COMMENT

Gary T. Burtless

Professor Garrison has written a provocative critique of the impact of Social Security on individual economic behavior. Before reviewing the general conclusion in his paper, I would like to summarize and comment upon some of his separate arguments.

In the first two major sections of the paper, Professor Garrison lays out and defends his use of the so-called Austrian model, a model with a long and venerable history in capital theory. I will not burden you with a description of the model, not because it is uninteresting but because it is not germane to most of the paper. The main conclusion drawn from Austrian theory appears to be the following proposition: As economists we have no valid scientific grounds to favor policies that encourage capital accumulation in preference to present consumption. For this reason, Garrison firmly rejects policies aimed at boosting capital accumulation, such as policies that have frequently been proposed as substitutes for the present Social Security system. According to the author, "If actually adopted, reforms of this sort would induce a pro-accumulation bias with the potential to create distortions that would rival the distortions created by the present system."[1] Although I generally agree with this proposition, I see no way in which it differs from the conclusion one would draw using ordinary neoclassical theory. So I must admit some confusion as to the advantages of the Austrian perspective in assessing capital-accumulation policies.

The next section of the paper considers specific policies to encourage saving for retirement in addition to, or in the place of, Social

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The author is a senior fellow at the Brookings Institution, Washington, D.C. 20036.

[1]Roger W. Garrison, "Misdirection of Labor and Capital under Social Security," *Cato Journal* 3 (Fall 1983): 518.

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Security. Since the author is opposed on scientific grounds to policies favoring accumulation, it should come as no surprise that he firmly rejects tax-preference schemes that favor savings over consumption or (what is nearly the same thing) that favor interest income over wage income. Because he states his conclusion in such clear, no-nonsense form, I can do no better than quote him directly: "Taxes cause both laborers and savers to receive less than the full value of the production that they make possible, but there is no sound economic basis for increasing the value discrepancy for one category of income in order to decrease it for the other."[2] He then goes on to discuss a number of rationalizations for particular tax preferences, but rejects each and every one of them without hesitation.

In his discussions, I detect the calm confidence of a poker player holding four aces. My own knowledge of economic theory and empirical fact does not give me quite the assurance in my views that Professor Garrison appears to possess. Nonetheless, I would agree with his main conclusion—in the best of all possible worlds. Regrettably, the world is less than perfect, especially in the vicinity of congressional tax-writing committees. Besides the many tax preferences that capital income already receives, progressive taxation gives capital income a fundamental advantage over labor income. In particular, the holder of capital assets can time his realization of capital gains so as to minimize or defer taxes over his lifetime. The wage earner has much less flexibility in arranging the receipt of his earnings, and thus can be expected to pay a higher lifetime tax on his human assets than he would on an equivalent amount of capital assets. The difference in after-tax lifetime returns can be substantial and may distort decisions about investing in human versus nonhuman capital.

For that reason, I have always felt that tax preferences for private pensions, as well as the more recent tax preference for private retirement savings from wages, are economically defensible. These preferences permit workers to "realize" some of their labor income in the years (after retirement) when their marginal tax rates are low. This advantage puts workers on a more nearly equal footing with capitalists, who have long had discretion about when they realize capital income for tax purposes.

Having rejected, on efficiency grounds, all proposals to replace Social Security with a tax-exemption scheme, Garrison then casts off from the calm waters of economic rationality to set sail on the tempestuous seas of political speculation. His voyage is not a prosperous

[2]Ibid., p. 519.

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one. He takes it as given that the current entrenchment of Social Security is in no way based on sound economic reasoning but is premised instead on a gigantic confidence trick being perpetrated on the economically unwary. These feckless souls, ignorant of what the author refers to as "the program's fraudulence and bankruptcy," are planning their lifetime consumption on the basis of Social Security's worthless promise to pay retirement benefits. He then gives us two "strategic" reasons for favoring the pro-accumulation policies that his economic arguments have just thoroughly demolished.

First, he argues that by adopting a policy that strongly encourages private retirement savings, the government would at last lift the veil of ignorance that hitherto has so obscured the true nature of Social Security. Finally aware of the unsoundness of the system, voters would resoundingly demand that it be abolished. Garrison's second "strategic" reason for favoring tax preferences for retirement savings is that it reduces the tax base. By concentrating taxes on a smaller fraction of national income, the author believes that the reform would mobilize forces opposed to tax rate increases and would thus potentially reduce the amount of taxes collected. The unstated assumption here is that taxes are too high—although by most accounts, federal tax revenues are now about $200 billion per year lower than projected outlays for the foreseeable future. Perhaps Garrison wishes to reduce *both* revenues and outlays, a proposition he should clearly state and explicitly defend. Let me note, however, that that particular proposition is completely irrelevant to the subject of his paper—the economic distortions arising out of Social Security.

In sum, after persuading the reader that tax preferences for retirement savings induce distortions in economic behavior, the author then perversely tries to argue that these additional distortions should be tolerated—even welcomed—because they may stimulate a tax rebellion. By logical extension, all tax levies should be as obnoxious as possible in order to maximize the political opposition to raising them. In my view, that is an extremely poor basis for tax policy, and one that I doubt has been defended by any serious scholar of public economics.

Garrison's political instincts are naive in the extreme. The main political strength of Social Security does not arise from the workers who are presently "deceived" by the system, but from current and future beneficiaries who could face serious income loss if the program were significantly reformed. Recent opinion polls show that younger people do not have much confidence in their future benefits, demonstrating that they have not been "fooled" by Social Security's promises. (Rather they appear to have been fooled by political oppo-

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nents like Garrison, who repeatedly state on the flimsiest of evidence that the program cannot survive.) But younger voters nonetheless support Social Security because they do not wish to reduce the standard of living currently enjoyed by the elderly, which is widely (and erroneously) perceived to be low. So the political coalition supporting Social Security is broad and firmly committed, while ideological opposition, although fervent, constitutes a small minority, as President Reagan painfully learned. Over the next 50 years I do not foresee a marked decline in the powerful coalition supporting Social Security. It is likely to grow stronger in the next century, as the huge baby-boom generation approaches retirement.

The next two sections of the paper analyze distortions caused by Social Security. The first of these is marred by a simple analytical error. Garrison posits two wage earners, whom I will call Mr. A. and Mr. B. Mr. A is satisfied with the retirement income—say $A—provided by Social Security, and hence does not accumulate any savings during his work life to supplement his Social Security check. Mr. B desires more retirement income than his Social Security allotment—say $B—and therefore sets aside some earnings during his work life to consume after retirement. According to the author, this example shows how Social Security changes the allocation of consumption between Mr. A and Mr. B, with Mr. A consuming more during his work life as a result of the pension benefits and Mr. B consuming less. This "distortion" reduces the welfare of both men.

This conclusion is wrong. In the example given, Social Security may or may not change the lifetime profile of consumption and may or may not affect welfare. One's conclusion depends critically on the contributions each individual is required to make to support the system. Suppose (for simplicity) that the interest rate is zero. In the absence of Social Security, Mr. A would have had to lay away $A′ if he wished to consume that amount during his retirement. If Social Security taxes were exactly $A′—that is, if taxes were equal to benefits—Mr. A's consumption would be in no way affected by Social Security (although his savings would be reduced). Similarly, if Mr. B's Social Security taxes were equal to his benefits, *his* consumption would be unaffected by the system. In neither case is the welfare of the individual affected by Social Security. But consider a more realistic case. Both Mr. A and Mr. B have contributed *less* in taxes than they eventually expect to receive in benefits. (This has in fact been the situation facing all cohorts of beneficiaries since 1940, when benefits were first paid.) Under the assumption, both Mr. A and Mr. B have been affected by Social Security, but neither is likely to complain, since the consumption of both has been raised. That is,

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economic welfare has been *increased*, contrary to Garrison's conclusion. I have tried to make the point, using the author's own illustration, that Social Security does not necessarily affect lifetime consumption patterns, and that even if it does, economic welfare may thereby be raised.

The author's last point is that Social Security introduces distortions because individuals are uncertain about the exact timing of the system's collapse. This uncertainty causes distortions in behavior because it causes some individuals to save more (in anticipation of the demise of the program) and others to change the date of their retirement. While I strongly reject the idea that Old-Age, Survivors, and Disability Insurance (OASDI) faces certain collapse—or even a reasonable probability of collapse—I do agree that current workers face uncertainty about the exact amount of their future benefits. However, the uncertainty is not all in one direction. Many well-informed observers confidently predict that Congress will eventually reduce the normal retirement age to 65 from 67, the scheduled retirement age in the next century.

More fundamentally, the author has forgotten that Social Security is no more uncertain than the alternative he prefers—namely, private savings to finance one's own retirement. Suppose a worker saves a certain portion of his earnings to finance his consumption during retirement. He faces two important risks, neither of which can be completely privately insured. First, his health may deteriorate unexpectedly, causing him to retire earlier than originally planned and forcing him to spread a smaller-than-expected nest egg over a longer-than-planned retirement. Second, the real rate of return on his savings may turn out to be lower than anticipated, leaving him with few assets to consume in his retirement. The Great Depression and the collapse of the financial market in the 1970s provide vivid reminders that private assets yield highly uncertain returns. In view of these risks, many individuals may be less uncertain about their future Social Security benefits than they are about the level of retirement consumption that can be financed out of private resources.

This point raises a more fundamental question about Garrison's entire analysis. In listing theoretical objections to the economic rationale of Social Security, he neglects to consider the simple economic reasons for the wide popularity of the program. He is correct that it is *theoretically* possible that Social Security has depressed aggregate savings, though both theory and evidence are ambiguous on this point. (And it is suggestive that the net savings rate has shown no perceptible decline since World War II, when benefits first began to be paid.) He is also correct in suggesting that Social Security

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benefits have induced somewhat earlier retirement, though this has been more than offset by the rise in women's labor-force participation. But the overwhelming majority of the electorate appears to support the program for a wide variety of reasons nowhere mentioned by Garrison. The system insures workers' families against income losses arising from death and disability. It reduces the number of orphaned, elderly, or disabled people who are destitute. It protects people from their own improvidence in youth. It shelters retirement income from capricious stock markets, unpredictable housing prices, and fluctuating interest and inflation rates. It permits the elderly to be less dependent on the charity of their relatives. And it allows the nonelderly to live apart from their older relatives. All this for less than 7 percent of private disposable income.[3] For most of the electorate, that is a bargain.

[3]See Henry J. Aaron, *Economic Effects of Social Security* (Washington, D.C.: Brookings Institution, 1982), p. 1.

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SUPPLY-SIDE EFFECTS OF SOCIAL INSURANCE

Norman B. Ture

Introduction

The Social Security Amendments of 1983 were hailed by their authors as the ultimate solution to the financing problems of the Social Security system. In view of the persistence of these problems throughout much of the system's history and the frequency with which this claim has been made on behalf of legislation in the past, any skepticism one may entertain about the future financial health of the system is certainly understandable.

What is remarkable about the assertions that "this time we've really fixed the system" is that there is any occasion to make them. Why should the world's largest "insurance" system need such frequent and drastic revision of its structure of benefits and "premiums"? If the private insurance industry had produced anything like this record of financial near-disaster, it would have been clear that the market for these services had failed. Yet no matter how often it is confronted by the imminent collapse of the Social Security system, the American public is always assured that the system must and can be saved. What never seems to come through loud and clear is that the system is fundamentally flawed. Nor does the public at large ever seem to ask whether we really need this system and whether there are not far better alternatives.

This is not to suggest that these questions have not been raised or that they have not undergone rigorous analytical examination. Surely one of the most constructive developments of recent years is the growing conviction that the provision of most, if not all, of the kinds

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The author is president of his own consulting firm, and chairman of the board, Institute for Research on the Economics of Taxation, Washington, D.C. 20036.

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of benefits now afforded by the social "insurance" system must be turned over to the private-market system.[1] To a significant extent, this view has been associated with the perception that a major economic problem confronting the United States is inadequate growth in the stock of privately owned capital and that the Social Security system has been a major factor in discouraging saving and private investment.[2] Far less attention has been directed to whether the social insurance system is essential to remedy private "market failure" and (as a corollary) whether the private market system would more efficiently provide the same sort of insurance.

This paper deals briefly with both of these sets of questions. First, it examines the effects of the social insurance system on private saving and capital accumulation. Second, the question of whether the social insurance system affords a net gain or loss of welfare is examined. In this context, the paper also examines the benefits of a private system of retirement insurance.

What I do not attempt to cover is the difficult problem of implementing transition to a private insurance system, given the conviction that the existing system of social insurance is fundamentally flawed. It is encouraging to see the efforts that are being made by serious-minded individuals in the private sector to solve this problem. It would be even better to see the administration and Congress demonstrate real political courage by undertaking similar efforts or by at least being willing to consider the results of the existing private studies.

Social Insurance, Saving, and Capital Formation

Much of the analysis of the effects of social insurance on private saving is derived from a life-cycle hypothesis about consumption and accumulation. This hypothesis implies, among other things, that people aim at a certain income for retirement and adjust their saving out of the incomes they earn over their working lives so as to meet this income target. In this context, the Social Security system is perceived as exerting opposing influences on private decisions to save. On the one hand, the earnings test is thought to encourage retirement at an earlier age and to discourage part-time employment after formal retirement. Given life expectancies, these responses are deemed to

[1]See Peter J. Ferrara, *Social Security: The Inherent Contradiction* (San Francisco: Cato Institute, 1980).

[2]See Martin S. Feldstein, "Social Security, Induced Retirement, and Aggregate Capital Accumulation," *Journal of Political Economy* 82 (September/October 1974): 905–26.

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raise the target for retirement income, thereby increasing the desire to save. On the other hand, the Social Security system is perceived to provide an annuity that substitutes for the retirement income that would otherwise have to be provided by private saving, thereby reducing the incentive to save. Furthermore, because payroll taxes reduce disposable income, the life-cycle hypothesis holds that they must tend to reduce current saving. As a result, the life-cycle hypothesis implies that one cannot predict, in the abstract, whether the Social Security system promotes or impedes private saving. It seems to follow, therefore, that an empirical investigation is necessary to determine the true effects of Social Security on private saving and investment behavior.

The life-cycle model has serious shortcomings. First, it incorrectly identifies the determinants of saving behavior by considering the target for retirement income as depending on the length of one's expected retirement and on one's preretirement income. That may be a useful approach for an insurance salesman in getting potential clients to focus on their "insurance needs," but sooner or later he must inform his potential client about premiums. At that point it becomes clear that the *cost* of the benefits is a major determinant of whether, and how much of those benefits, the client wants to buy. Surely the cost of acquiring any given amount of retirement income should be seen as a principal determinant of private saving. In turn, this must mean that the income targets for retirement (if they exist) must be variable rather than stationary. But if the target for retirement income is not a fixed amount, then the dollar amount of retirement benefits from Social Security will not necessarily have any systematic influence on the amount of private saving for retirement.

In the second place, the perception that Social Security retirement benefits are a substitute for the returns on private saving, however acceptable from the viewpoint of the individual, is clearly not acceptable from the aggregate viewpoint. Nothing in the Social Security system's intergenerational tax/pay process adds to the aggregate income-producing capacity of the economy. The total amount of benefits promised to any generation of retirees represents only a redistribution of a given amount of income; it does *not* represent any additional income produced by increments to the stock of capital. For this reason, even if a potential or actual beneficiary perceives the expected flow of Social Security benefits as a perfect substitute for returns on his private retirement saving, the same person and/or others must view that flow as imposing an equal drain on the rewards for working and saving. If the present value of expected benefits from

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Social Security is deemed to be an addition to the net worth of the beneficiaries, then the present value of the obligations to fund the transfers must be seen as an equal decrease in net worth. There can be no positive Social Security net wealth.

Those who persist in maintaining that there is a positive Social Security net wealth that substitutes for private-sector wealth implicitly assume that people perceive only the flow of benefits while ignoring the flow of payroll taxes that are used to fund the benefits. Such an assertion may be convenient for econometric exercises, but it certainly is not a view that accords with reality or with clear thinking.

The notion of a positive Social Security net wealth cannot be rescued by demonstrating that the present value of the benefits an individual will receive exceeds the present value of the payroll taxes he will have paid (including the taxes paid by his employer on his behalf). At any point in time, the total amount of benefits paid must necessarily equal the total amount of withdrawals from the income stream of some people. Only if part or all of these withdrawals are hidden from the individuals from whose income the withdrawals are made could it be assumed that the aggregate of households behaves as if there were positive Social Security net wealth. No Ponzi-scheme explanation can validate the notion that there is any positive Social Security net wealth that substitutes for private capital.

In short, the conventional approach to analyzing the effects of Social Security on private saving and capital formation is unsatisfactory. And the econometric exercises conducted within this framework are of little value in explaining or measuring the effect of Social Security on private capital.[3]

An alternative—and superior—analytical framework leads in a straightforward way to the conclusion that Social Security erodes private saving. One element in this analysis is the use of national income accounting to assess the *initial* impact of Social Security on Gross Private Saving (GPS)—Gross National Product (GNP) less consumption and less taxes. Obviously, the greater the amount of taxes, the less the amount of GPS, unless it is assumed that consumption declines in an amount equal to taxes. This would be true if and only if such taxes raised the cost of consumption relative to saving enough to induce an equal dollar decrease in consumption. A payroll tax, however, does not raise the cost of consumption relative

[3]The pattern for much of the econometric investigation of the effect of Social Security on saving was set by Feldstein in his 1974 paper, "Social Security, Induced Retirement, and Aggregate Capital Accumulation." The technical quality of the Feldstein study apart, the fundamental concepts employed therein are faulty, as explained above.

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to the cost of saving; it increases the cost of labor relative to leisure.[4] There is, therefore, no increase in the fraction of GNP that is devoted to saving as the result of imposition of payroll taxes. Moreover, since Social Security benefits do not represent either the value of the contribution of current labor or capital services to total production, the immediate effect of the payroll tax in lowering GPS is not offset by an increase in GNP. Payroll taxes result in an unqualified reduction in GPS.

In the long run, the effect of Social Security taxes is to reduce the supply of labor, thereby reducing total output. As a result, aggregate saving, i.e., aggregate additions to the stock of capital, must also be reduced.

Social Insurance and Efficiency

In addition to the distortions discussed above, the efficiency criterion pertains to the effects of social insurance on total utility. The question then arises: Does the Social Security system reduce an individual's utility by distorting his time paths for consumption and accumulation?

The Option of Private Retirement Insurance

To provide a conceptual framework for answering this question, consider first the results likely in a risky world with imperfect knowledge, uncertainty about the outcomes of economic decisions, and costly information, but in which there is no *compulsory* insurance system. In such a world each person must decide on his own timing of consumption and saving. These choices are based on each individual's perception of the probability distributions underlying the relevant phenomena, e.g., continuity and duration of employment, illness and other events affecting his productivity, his longevity, and the productivity of the capital he acquires. The existence of risks creates the conditions in which there is a market for a private insurance industry. Although insurance does not alter the total losses that occur, it redistributes those losses, provided the premiums equal the losses. This means that those who incur losses that are less than the mean expected value of total losses are the transferors to those individuals who have incurred losses greater than that mean.

[4]It also raises the cost of labor services relative to capital services, resulting in a higher capital/labor ratio. This change in relative costs does not result from a decrease in the cost of capital services, i.e., in the amount of current consumption that must be foregone to obtain a given amount of output from the addition of another unit of capital. It does not, therefore, increase the proportion of total income that individuals want to save.

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In the individual's choice of the time paths of consumption and saving, he may include in his portfolio an insurance policy that provides him with an annuity at the time of retirement, due to either voluntary choice or illness. He may also want to include in his policy a provision for income during periods of unemployment prior to his chosen retirement date. Finally, he may want his policy to provide survivors benefits if he chooses to leave an estate.

The amount of the retirement income and income-assurance benefits an individual can provide for himself at any time will be constrained by his available resources and by the marginal productivity of his accumulated capital. Benefits do not depend on any systematic transfer of income from nonannuitants to annuitants. To be sure, some transfers are involved within the insurance system, but these transfers are random. The *average* amount of such transfers included in the benefits of all the insured must be zero. If it were other than zero for any length of time, appropriate revisions in the actuarial calculations and premiums would be made.

Opportunities for realizing economies of scale in insurance may result in group contracts to cover some of the insurable phenomena. Group insurance should tend to reduce the transfer element included in insurance benefits, provided the groupings are based on variables relevant to the shape of the probability distribution of these phenomena. Some transfer element remains, but taking all the insured together, transfers should net out entirely. Aggregate benefits for retirement, then, are a function only of the marginal productivity of capital.

A snapshot of the private insurance system at any moment in time would reveal that retirees receiving annuities and other insurance proceeds or returns on their own assets acquired over their working lives are paying nothing into retirement funds, while workers are receiving no benefits but are contributing to such funds. This does not mean that the system is redistributing income between generations. The present generation of workers is not transferring income, in the form of retirement benefits, to an earlier, now retired, working generation. The amount of retirees' benefits depends on how much they had earlier saved and on the marginal productivity of the capital to which they have acquired claims. The present generation of workers can be said to be contributing to present retirees' annuities only in the sense that the conditions of labor supply (taken in conjunction with the stock of capital, the conditions of supply of capital, the state of the industrial arts, and the technical production relationships) determine the productivity of capital that is the source of the benefits flow. In no literal sense are present workers financing the retirement of former workers.

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The total amounts consumed and saved at any given time represent the most efficient state of affairs, given the risks and costs involved in the institutional arrangements for averting risk. Of course, some individuals will wind up with less than their optimum wealth accumulations and others with more, simply because without perfect foresight, their forecasts of the relevant phenomena are not perfectly realized. The individuals who were overanxious about the future will find that they have consumed less over their working lives than they would have, had they had perfect foresight. They will approach and reach retirement with larger accumulations than they had earlier aspired to, and if their utility functions have not changed, they might attempt a one-shot adjustment in their total assets by increasing their consumption. On the whole, however, they are likely to retire with some "excess" endowment. Other individuals, meanwhile, will have accumulated "too little," having been excessively confident during their working years. Some of these may be destitute and may be sustained either by charity or not at all.

These errors in forecasts should cancel out for all individuals. If, for some reason, there were a systematic bias in people's forecasts against the actual distributions of events around their mean values, insurance premiums would be higher or lower than required by the actual distributions. Unless individuals were completely unresponsive to changes in the cost of retirement insurance, the amount of insurance acquired would be different from the amount that would be optimum for the actual distributions. The difference in the amount of insurance proceeds actually paid, therefore, would be offset to some degree—possibly more than 100 percent—by the differences in the amount of premiums paid. Whether this offset would be perfect would depend on the price elasticity of demand for insurance, but the degree of market failure, even if the offset were not perfect, would be slight.

In admittedly oversimplified terms, the preceding discussion delineates the kind of private insurance system and how it would operate to maximize efficiency if there were no impediments imposed by the public sector. Against this outline, one can evaluate the efficiency implications of the existing social insurance system.

Efficiency Implications of Social Insurance

Suppose public-policy makers insist on providing some systematic, collective remedy for the underaccumulation by those who forecast poorly. The resulting social "insurance" system might require everyone to increase his accumulation rate. The result would be an accumulation that is excessive and a time path of consumption that is too

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low. The social "insurance" system might be less than universal, requiring only certain groups of persons, deemed to be less-than-adequate accumulators, to increase their saving. In this case, the utility lost by the selected groups would not be compensated for by anyone else, since presumably everyone was already at a preferred rate of saving, given his own budget constraint and the productivity of capital. The social "insurance" system might be designed as a kind of organized charity, levying taxes on those deemed to be relatively affluent in order to transfer income to the poor. Those paying the taxes would then suffer losses in their utility. Moreover, the economy as a whole would sustain an efficiency loss in terms of changes in the composition of real output and/or in the mix of production inputs. Those receiving the transfer payments, of course, would realize utility gains.

Some gains in utility may also be realized by the taxpayers. The destitute may become less numerous or less poor, less obvious, and hence, less a source of psychic distress to those who behold them; the amounts expended for private charity may be reduced; the unpleasant impact of poverty on the physical surroundings may be abated; and the inefficiently rationed demands of the poor for publicly provided services may be lessened. On the whole, however, there is no a priori case to be made that the sum of these gains would exceed the losses.[5]

Another argument for social insurance is that the net efficiency loss from some form of compulsory retirement system disappears and is replaced by a net gain when one takes account of real-world imperfections. The argument is that it is not merely the lack of perfect foresight that prevents an individual from realizing an optimum time path of consumption and saving; more significant are the objective events over which he has no control and for which he cannot obtain sufficient information, except at extraordinary costs. That is, if he believes that the information costs exceed the benefits to be derived from such information by way of better decisions about consumption and investment, and if these information costs depend on events external to his behavior, then there may conceivably be an efficiency gain in relieving him of the decision-making responsibility.

This argument obviously contains the principal elements of the externality argument for public decision making. Even so, it does

[5]These alternatives should not be perceived as equivalent in terms of the efficiency losses they involve. In the first two cases, the efficiency loss results from the social requirement for too much private saving, too much additional private capital. In the last case, in contrast, the tax/pay system must result in too little saving and too little private capital accumulation.

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not support a *compulsory* retirement system. It merely suggests that we should make available to the most poorly informed some type of retirement insurance in which premiums and benefits are based upon information that such individuals cannot economically acquire by their own efforts, and that we should advise them of the pertinent costs and benefits.

Against the criteria suggested above, the Social Security system emerges as seriously deficient. The system is compulsory and well-nigh universal. Participation, therefore, implies nothing about any covered individual's preferences and perceptions regarding an optimum time path of consumption and saving. While the required participation undoubtedly conforms closely with the preferences of some of the covered individuals, it defies credulity that it does so for most of them. To assume the contrary requires one to assume an extraordinarily close clustering of participants' preferences around the mean values of the principal elements of the system.

Beyond this basic violation of efficiency, the Social Security system involves other significant efficiency losses. Since the amount of "premiums" paid by any covered employee is a function only of the amount of his wages or salary (given the statutory rate and base provisions), there is no a priori basis for assuming that the premium he pays at any time conforms with his preferred allocation between consumption and saving. Similarly, there is no basis for claiming that the path of consumption or saving implied by the premiums is congruent with his preferred path.

Moreover, one would have to assume lack of conformance even if the annuity accumulated on the employee's behalf were equivalent to what he might obtain independently in the marketplace with the same annual premium payments. Of course, his "premium" payments do not purchase a market-determined annuity for him, but rather an annuity that is based principally on his years of coverage and on his taxable earnings in covered employment. Thus, regardless of whether the Social Security Trust Fund is on an "actuarially" sound basis—in the sense that its total receipts are adequate to fund the total benefits paid—no present-day contributor is likely to receive benefits determined by a market rate of interest on his "premiums." And no present-day beneficiary's benefits are likely to be equal to the annuity that would result from the wealth accumulated, at market-determined rates, from the premiums he actually paid. In other words, for no given individual are the premiums paid and the benefits received likely to be related by the market measure of the marginal productivity of capital.

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As in the case of private insurance, some covered employees will eventually wind up as transferors and some as transferees under the social "insurance" system.[6] In contrast with private insurance, however, the income transfers are not functions of the difference between an individual's actual experience and the mean value of the probability distributions of the relevant events that determine how much he actually has accumulated and how much he is contractually obligated to receive. In the case of private annuities (ignoring survivors benefits), the transferors are those who die before they reach the actuarial mean life expectancy that determined the amount of premium required per dollar of annuity, while the transferees are those who live longer than that mean. In the case of Social Security, on the other hand, the transferors and the transferees are distributed with respect to a much larger number of variables: how much they would have saved otherwise, into what kind of capital or claims they would have channeled their savings, when they would have chosen to begin to receive annuity benefits, how much survivors benefits they would have opted for, and so on, as well as their longevity.

Conclusion

Whether assessed in terms of how it impairs growth in the stock of capital and how it distorts the labor/leisure choice or in terms of the more traditional criteria of welfare economics, the social insurance system is basically deficient. These deficiencies are not addressed by concerns about the present or prospective balance in the trust fund, i.e., about the adequacy of financing the legislated benefits. The 1983 Social Security legislation has not repaired the fundamental flaws in the social insurance system; indeed, it has augmented them.

The same sort of examination that reveals the inefficiencies of social insurance urges that the private insurance industry, if unencumbered by a large government presence, would far more effectively satisfy demands for retirement income and income assurance. Notwithstanding the differences in analytical approach, there is a growing consensus that ultimately the government should—some would insist must—relinquish its dominance in this aspect of our economic life. At minimum, the Social Security system should revert to what it was originally intended to be: a supplement to private provision for retirement and income protection.

[6]The *intra*generational transfer under social insurance is discussed in Anthony Pellechio and Gordon Goodfellow, in "Individual Gains and Losses from Social Security before and after the 1983 Amendments," *Cato Journal* 3 (Fall 1983): 417–42.

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ACHIEVING A "LENINIST" STRATEGY

Stuart Butler and Peter Germanis

Introduction

Marx believed that capitalism was doomed by its inherent contradictions, and that it would inevitably collapse—to be replaced by the next stage on the ladder leading to the socialist Utopia.

Lenin also believed that capitalism was doomed by its inherent contradictions, and would inevitably collapse. But just to be on the safe side, he sought to mobilize the working class, in alliance with other key elements in political society, both to hasten the collapse and to ensure that the result conformed with his interpretation of the proletarian state. Unlike many other socialists at the time, Lenin recognized that fundamental change is contingent both upon a movement's ability to create a focused political coalition and upon its success in isolating and weakening its opponents.

As we contemplate basic reform of the Social Security system, we would do well to draw a few lessons from the Leninist strategy. Many critics of the present system believe, as Marx and Lenin did of capitalism, that the system's days are numbered because of its contradictory objectives of attempting to provide both welfare and insurance. All that really needs to be done, they contend, is to point out these inherent flaws to the taxpayers and to show them that Social Security would be vastly improved if it were restructured into a predominantly private system. Convinced by the undeniable facts and logic, individuals supposedly would then rise up and demand that their representatives make the appropriate reforms.

While this may indeed happen, the public's reaction last year against politicians who simply noted the deep problems of the system, and the absence of even a recognition of the underlying problems during this spring's Social Security "reform," suggest that it

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Stuart Butler is director of domestic policy studies and Peter Germanis is a policy analyst at the Heritage Foundation, Washington, D.C. 20002.

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will be a long time before citizen indignation will cause radical change to take place. Therefore, if we are to achieve basic changes in the system, we must first prepare the political ground so that the fiasco of the last 18 months is not repeated.

First, we must recognize that there is a firm coalition behind the present Social Security system, and that this coalition has been very effective in winning political concessions for many years. Before Social Security can be reformed, we must begin to divide this coalition and cast doubt on the picture of reality it presents to the general public.

Second, we must recognize that we need more than a manifesto—even one as cogent and persuasive as that provided by Peter Ferrara.[1] What we must do is construct a coalition around the Ferrara plan, a coalition that will gain directly from its implementation. That coalition should consist of not only those who will reap benefits from the IRA-based private system Ferrara has proposed but also the banks, insurance companies, and other institutions that will gain from providing such plans to the public.

As we construct and consolidate this coalition, we must press for modest changes in the laws and regulations designed to make private pension options more attractive, and we must expose the fundamental flaws and contradictions in the existing system. In so doing, we will strengthen the coalition for privatizing Social Security and we will weaken the coalition for retaining or expanding the current system. By approaching the problem in this way, we may be ready for the next crisis in Social Security—ready with a strong coalition for change, a weakened coalition supporting the current system, and a general public familiar with the private-sector option.

Framework for Reform

Peter Ferrara's "family security plan" provides a sound framework for reform.[2] The Ferrara plan resolves the contradiction within the existing system and provides a realistic phase-in process for a private pension plan. Recent efforts to publicize and implement the Ferrara plan, however, only confirm the fact that a successful reform strategy must be designed within a framework of well-understood constraints

[1]See Peter J. Ferrara, *Social Security: The Inherent Contradiction* (San Francisco: Cato Institute, 1980); *Social Security: Averting the Crisis* (Washington, D.C.: Cato Institute, 1982); and *Social Security Reform: The Family [Security] Plan* (Washington, D.C.: Heritage Foundation, 1982).

[2]Ferrara, *The Family [Security] Plan,* pp. 49–73.

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and opportunities; otherwise we will fall into the same political traps that have discouraged many a would-be reformer.

In an effort to identify a broad framework for Social Security reform, the Heritage Foundation (1982) gathered various experts, who discussed the essential ingredients of reform. The principles and observations that emerged from that gathering can now be summarized.[3]

Calming Existing Beneficiaries

The sine qua non of any successful Social Security reform strategy must be an assurance to those already retired or nearing retirement that their benefits will be paid in full. It was irresponsible in the first place for the federal government to promise unrealistic benefits. But it would be even more irresponsible now to break faith with the millions of people who have based their retirement plans on these expected benefits. Instead of spreading widespread panic among our elderly, which will only undermine our efforts to reform the system, we should acknowledge the system's liabilities as a total writeoff.

From a purely political standpoint, it should be remembered that the elderly represent a very powerful and vocal interest group. This power was reflected in the recent bailout plan, which made no effort to address the system's underlying structural problems. One congressman, with disarming frankness, implicitly evidenced that considerable power when he explained his position on Social Security reform: "I have no intention of trying to explain what needs to be done, just give me a vote on something that can save the damn thing until I retire."[4]

The political power of the elderly will only increase in the future. The proportion of the population over 65 will rise steadily, from 11.3 percent today to 18.3 percent by 2030. So any proposal aimed at cutting benefits will face increasingly stiff opposition from the elderly, undermining the prospects for genuine reform. Any plan to change the system must therefore be neutral or (better still) clearly advantageous to senior citizens. By accepting this principle, we may succeed in neutralizing the most powerful element of the coalition that opposes structural reform.

Educating the Public

A second prerequisite for reform is to improve the public's understanding of the current program. During the recent financing crisis,

[3]For an edited transcript of that conference, see Peter Germanis and John Palffy, eds., *Rebuilding Social Security,* Heritage Lectures 18 (Washington, D.C.: Heritage Foundation, 1982).

[4]Rep. Marvin Leath (D-Tex.) quoting one of his colleagues in "Social Security Expediency," *Washington Times,* March 23, 1983.

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there was only a vague awareness among the general population that the system was in serious trouble; the true nature of the problem and the proposed reforms were understood by very few Americans.

A comprehensive program of economic education must confront people with the facts about Social Security and the problems it faces. The many myths surrounding the system must be dispelled, especially the popular belief that Social Security is an "insurance" program financed by "contributions" that provide an "earned annuity." That many have come to rely on Social Security as their major or sole means of support, not realizing that it was originally intended only to supplement other sources of retirement income, is apparent from a reading of the popular press. Over the years, the program has become surrounded by a cloak of demagoguery and misinformation, woven by political leaders and interest groups seeking to further their own ends. If the public is ever to support real Social Security reform, this cloak must be removed.

Recognizing Successful Alternatives

Despite the unwillingness of Congress to undertake or even consider real reform, the public has shown a great deal of interest in private alternatives to Social Security. In a poll conducted by the Sindlinger Company for the Heritage Foundation, for instance, a majority of people surveyed said that they would favor a voluntary system. Even more people expressed the view that the private sector would be a more efficient vehicle than Social Security for providing pension benefits. The recent upsurge in savings put into Individual Retirement Accounts (IRAs) is further testimony to the public's enthusiasm for private pension plans. A New York Times/CBS News poll suggested that Americans had invested about $30 billion in tax-free IRAs for the 1982 tax year, which is much higher than the Treasury Department had estimated. According to the poll, nearly one out of every five employed adults had opened an account by early April.[5] Extending this option as an alternative to Social Security could both increase savings and provide funds for long-term capital investments.

A restricted private option is now being tried in Great Britain. Britain has a two-tier retirement benefit system made up of a mandatory basic pension plan and an earnings-related pension. It is possible, however, to opt out of the earnings-related pension (but not the basic pension). The employer has the legal responsibility of

[5]Robert A. Bennett, "I.R.A.s a Hit With Taxpayer," *New York Times*, April 15, 1983, p. D1.

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making the decision to allow the employees to contract out of the plan. If an employer does decide on the contracting-out option, he is required to provide private pension benefits at least equal to those in the government program. This contracting-out scheme for the second tier has enjoyed a great deal of success. Since 1978, when it was fully initiated, nearly 45 percent of all British workers have enrolled in private pension programs.

The British system indicates that many employees are willing to choose a private retirement option in preference to a government-guaranteed plan. It also indicates that workers are willing to pay a price to leave Social Security. British workers who opt out of the earnings-related element of Social Security do not obtain a reduction in payroll taxes that is equal to the benefits they forgo. In other words, those who opt out still pay some tax to support existing and future beneficiaries of the government system.

According to John Goodman, the payroll-tax reduction available to those who contract out is carefully designed to be just large enough to encourage enough workers to opt out (thereby reducing future liabilities), while ensuring that these workers still provide considerable tax revenue to subsidize existing beneficiaries.[6] It does seem that the price people are willing to pay to leave Social Security is substantial. Perhaps in the United States it is large enough that those wishing to leave the system can cover a large part of its current obligations to beneficiaries while it still enables a high proportion of workers to opt out, thus reducing the system's future obligations.

A Plan of Action

The background issues discussed above suggest a political strategy to achieve basic reform of the Social Security system in the fashion suggested by Peter Ferrara. There are two main elements to this strategy.

The first element consists of a campaign to achieve small legislative changes that embellish the present IRA system, making it in practice a small-scale private Social Security system that can supplement the federal system. As part of this campaign, the natural constituency for an enlarged IRA system must be identified and welded into a coalition for political change. If these objectives are achieved, we will meet the next financial crisis in Social Security with a private alternative ready in the wings—an alternative with which the public is familiar and comfortable, and one that has the backing of a powerful political force.

[6]John Goodman, "Lessons From Abroad," in Germanis and Palffy, pp. 23–31.

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The second main element in our reform strategy involves what one might crudely call guerrilla warfare against both the current Social Security system and the coalition that supports it. An economic education campaign, assisted by modest changes in the law, must be undertaken to demonstrate the weaknesses of the existing system and to allow it to be compared accurately (and therefore unfavorably) with the private alternative. In addition, methods of neutralizing, buying out, or winning over key segments of the Social Security coalition must be explored and formulated into legislative initiatives. The objective of this element of the strategy complements the first. The aim is to weaken political support for the present system when the next financial crisis appears. This two-pronged strategy will now be considered in more detail.

Creating a Private Model

Expanding IRAs

IRAs are a powerful vehicle for introducing a private Social Security system. They are extremely popular with the public. No politician wishing to be reelected would even suggest that the tax deduction for IRAs should be eliminated. Building on this strong political support, proponents of a private Social Security system should press for an extension of the deduction. No doubt Congress would find it difficult to reject proposals designed to allow workers to provide a more secure retirement for themselves.

The aim should be to secure legislation that not only indexes the basic IRA deduction and makes it available to all (including nonworking spouses) but also allows people to take a much larger IRA deduction if it is used to purchase old-age health insurance, disability insurance, or other benefits now available through Social Security. Ideally, this "super IRA" would be close to that of the Social Security system in both size and structure. As the payroll-tax rate increases, the maximum tax-deductible contribution to an IRA should increase to the same cash level. Similarly, the prescribed allocation of an IRA among retirement income, health insurance, and other uses should reflect the equivalent allocation of the Social Security tax.

The reason for designing a "super IRA" law with these restrictions is purely political. Expanding the IRA system in this way would make it a private prototype of Social Security. People could then compare the two alternatives. The public would gradually become more familiar with the private option, and would no doubt view it as a parallel system. If that did happen, it would be far easier than it is

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now to persuade people to adopt the private plan as their principal source of old-age insurance and retirement income.

Coalition Building

Building a constituency for Social Security reform requires mobilizing the various coalitions that stand to benefit from the change. Such a constituency is already extensive, but mobilizing it could become a self-generating process. If an extension in the IRA system is achieved, for instance, it will expand the natural self-interest constituency by making IRAs more attractive to more people. This wider constituency will then be better able to achieve further extensions that in turn will further expand the constituency. This self-generating process in the private sector is identical to the political process that has forced programs in the public sector to grow and serve ever larger constituencies.

The business community, and financial institutions in particular, would be an obvious element in the constituency. Not only does business have a great deal to gain from a reform effort designed to stimulate private savings, but it also has the power to be politically influential and to be instrumental in mounting a public education campaign. This influence was clearly demonstrated in the fight to repeal withholding on interest and dividend income. The banking industry's ability to lobby and garner support for the repeal effort led many in Congress to reverse their earlier votes. Financial institutions, likewise, have been extremely effective in marketing various types of savings plans, such as All-Savers Certificates and IRAs, thereby building up public acceptance of these innovations.

Interest groups concerned with Social Security reform can be divided into the young, the middle-aged working population, and the retired or those nearing retirement. Of these, the young are the most obvious constituency for reform and a natural ally for the private alternative. The overwhelming majority of people in this group have stated repeatedly that they have little or no confidence in the present Social Security system. Discontentment will only grow as the taxes needed to support the system continue to rise, and as the prospects for a reasonable return on one's "contribution" continue to fade.

Despite misgivings about Social Security, however, the young have yet to have a significant impact on the political process as it relates to reform measures. It is imperative, therefore, that they be informed about the problems inherent in the current system and that they be organized behind the private alternative.

Clearly, an important thread running through the entire strategy is education. An education campaign is needed to gain the support of

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key individuals in the media as well as to win over vital constituencies for political reform. The banking industry and other business groups that can benefit from expanded IRAs must be encouraged to play a central role in educating the public about the benefits of the private plan. They can do this both through their commercial advertising and through public relations.

Weakening the Opposition

Individual Accounts

To emphasize how unfavorably Social Security compares with the private alternative, the Social Security Administration should be required to establish an individual account for each person participating in the program. Furthermore, each person should be provided with an annual statement showing how much he has paid into the system and what benefits he can expect to receive. Individuals could then compare their returns from private investment with their returns under Social Security. Such a scheme would illustrate in cold numbers just what the program means for different individuals, and would help reveal the inter- and intragenerational distribution that occurs under the current system. The retired population might then come to realize that they have not purchased an earned annuity but instead are receiving a tremendous welfare subsidy. Younger workers, on the other hand, would see just how much of a loss they are taking by participating in the program. This mechanism for demonstrating the individual gains and losses that occur under Social Security is a key step in weakening public support for the present system.[7]

The technology for creating a reporting system already exists. Using it simply requires an improvement in the computer system of the Social Security Administration. The SSA, however, undoubtedly would claim that the enormous cost and complexity of such a system would prevent it from providing what would be highly embarrassing information. Fortunately, there are private-sector companies, such as Accucomp Financial Services, that are willing to compile the necessary information from an employee's tax returns for a very modest fee. (Accucomp does it for $35.)[8] The SSA could be required to contract out the service to such companies, or taxpayers could receive a tax credit for arranging it themselves.

[7]Anthony Pellechio and Gordon Goodfellow have calculated these in "Individual Gains and Losses from Social Security before and after the 1983 Amendments," *Cato Journal* 3 (Fall 1983): 417–42.

[8]See Accucomp's ad in the 1983 edition of *Money Guide* (published by the editors of *Money*), p. 61.

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Detaching Supporters of Social Security

The final element of the strategy must be to propose moving to a private Social Security system in such a way as to detach, or at least neutralize, segments of the coalition that supports the existing system. A necessary step toward this objective is to honor all outstanding claims on the current system. Without such a commitment, we can never overcome the political opposition to reform, because the retired (or nearly retired) population will continue to strongly oppose any package that threatens to significantly reduce their benefits. Retaining the obligation to fund existing liabilities, however, will necessarily place constraints on the mechanisms that can be used to move the country towards a private system.

The problem of implementing a private system makes the British model particularly attractive. It is clear, in Britain at least, that workers are quite prepared to make some payments into Social Security (even though they will not receive benefits), provided they acquire the right to escape from a governmentally operated retirement system in which they have little confidence. We should consider, therefore, modifying Peter Ferrara's phase-in plan.[9]

Under Ferrara's plan, workers would be allowed to invest part, and eventually all, of the money they now pay into Social Security in expanded IRAs, in return for a corresponding reduction in their future Social Security benefits. Under our proposed modification, workers who choose to opt out of the system would not only lose their corresponding future benefits but would even have them reduced somewhat further for the privilege of getting out of Social Security. This added reduction in benefits could be viewed as a tax that would be used to pay off the system's remaining obligations.

An interim "opting-out tax" hardly conforms with the principles of fairness; yet it makes good political sense. If the support for leaving Social Security is as great as it seems, then it is unlikely that the level of contracting out will be significantly reduced by requiring workers to make some payment into the system while they withdraw and lose benefits (assuming, for the sake of argument, that they ever would have received those benefits!). But the opting-out tax would have important political advantages. It would serve to calm the fears of the elderly, because the net phase-out losses to the Social Security fund would be smaller under opting out than under the Ferrara plan, for virtually the same reduction in future liabilities. Hence, under

[9]We refer specifically to Ferrara's "family security plan," as discussed in *The Family [Security] Plan*, pp. 49–73.

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an opting-out plan the support needed from general revenues would be smaller, and the threat to the trust funds would be reduced.

This modification would slightly dampen the enthusiasm of young workers, who are a strong segment of the coalition for change. But on the other hand, this modification would help to meet the concerns of the elderly and of the taxpayers and beneficiaries of federal programs who might resist the use of general revenues to cover the phase-in period.

Detaching workers who have made substantial tax payments into Social Security may not prove to be too difficult. A number of proposals have been put forward in which the worker's accumulated "contributions," plus interest, would be given to him in form of an interest-bearing bond, payable at retirement.[10] This bond would have a market value and could be sold, with the proceeds to be invested in a tax-deductible IRA. Using an appropriate version of this proposal should make it possible to gain some support even from those who have a substantial stake in the current system.

Conclusion

The last two years have demonstrated beyond a doubt that Social Security can be reformed only by treating the issue primarily as a political problem. There is little point in arguing over the nuances of theoretical plans if the political dynamics are not altered; no amount of logic will overcome an unfavorable coalition of interest groups.

It is also clear that the strategy we adopt must be flexible. It would be self-defeating to lay down a rigid blueprint and blindly adhere to it. Indeed, we must be prepared to refine segments of the plan, such as the opting-out mechanism or the design of the "super IRA," to meet the changing political circumstances.

Finally, we must be prepared for a long campaign. The next Social Security crisis may be further away than many people believe. Or perhaps it will occur before the reform coalition is strong enough to achieve a political breakthrough. In either case, it could be many years before the conditions are such that a radical reform of Social Security is possible. But then, as Lenin well knew, to be a successful revolutionary, one must also be patient and consistently plan for real reform.

[10]See Ferrara, *The Inherent Contradiction*, pp. 340–50.

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THE POLITICAL FEASIBILITY OF PRIVATIZING SOCIAL SECURITY

Marilyn R. Flowers

Butler and Germanis are concerned with the feasibility of constructing a majority coalition to phase out the Social Security retirement program and replace it with an explicit welfare program for the needy elderly. They are also concerned with the provision of appropriate government and private incentives for working Americans to save and invest privately, to ensure themselves adequate retirement income.

In one important respect, their strategy is not "Leninist" at all. Butler and Germanis seek to form a political coalition. While I am not a student of Marxist-Leninist thought, I do feel reasonably confident that Lenin gave little thought to the possibility of achieving his goal with ballots rather than bullets. Fortunately, we are blessed in the United States by the existence of well-established democratic institutions within which to work for change, and a commitment from even our most fervent reformers that democratic process is the only legitimate avenue for change.

This is not to say that democracy as we know it is flawless. The history of Social Security illustrates some of the problems. Many of us today regret the way in which the Social Security program was allowed to develop. However, we are not surprised by that pattern of development. One needs only to read Edgar Browning's classic paper "Why the Social Insurance Budget Is Too Large in a Democracy"[1] to understand the political appeal of starting a pay-as-you-go government pension program. Early generations of retirees reap tremendous windfall benefits. Future generations, who will almost unavoidably be harmed, simply are not around in sufficient numbers to vote in opposition.

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The author is associate professor of economics, University of Oklahoma, Norman, Okla. 73019.

[1]Edgar K. Browning, "Why the Social Insurance Budget Is Too Large in a Democracy," *Economic Inquiry* 13 (September 1975): 373–87.

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The same problem exists in reverse if we try to phase out an existing pay-as-you-go program. There are identifiable groups of current voters who will be harmed by the phase-out. Those with the most to gain—future generations—do not have any political clout. If they did, we would not be in our present quandary. Can we realistically expect a majority of voters to support a phase-out—"privatization"—at any time in the future? This question has not been adequately addressed by Butler and Germanis. It is not nearly as obvious to me as it seems to them that such a coalition is waiting in the wings. In particular, I am not convinced that expanding IRAs will help as much as they think it will.

Let me illustrate the problem as I see it with a very simple example. Suppose we start out with a fully mature pay-as-you-go pension scheme in a society that has zero population growth and zero economic growth.[2] At any point in time, there are four workers for every retiree. Each worker pays $10 in payroll tax during each of the four working periods of his or her life and receives a $40 retirement benefit during the last period. This reflects the return provided by a pay-as-you-go system that is equal to the growth rate in the economy.

This type of program would be a good deal for all individuals if the growth rate in the economy were greater than the market interest rate. However, most economists regard this as an unlikely circumstance. The analysis that follows is based on the alternative assumption that the rate of economic growth is lower than the interest rate. In this case, the first retirees in the program enjoy a windfall gain. They pay taxes over only a portion of their working lives but receive full benefits. However, the program will be a bad deal for workers who must pay taxes throughout their entire working careers before becoming entitled to a retirement benefit. This is because the implicit "return" that they receive on their tax payments is lower than the return they could have received had their money been invested in the capital market.

Despite this bad deal, political support for the government pension program will not necessarily evaporate when it reaches maturity. To illustrate the problem of achieving consensus among the currently living population, let us consider, within the context of our simple model, a proposal to phase out the pay-as-you-go system along the lines suggested by Peter Ferrara.[3] All existing entitlements will be

[2]The zero-growth assumption is purely for analytical convenience and does not affect any of the basic conclusions of the analysis.

[3]Peter J. Ferrara, *Social Security: Averting the Crisis* (Washington, D.C.: Cato Institute, 1982).

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honored, but additional entitlements will be allowed to accumulate. If we take any five-person group of one retiree and four workers with the numbers 1 through 4 designating ages from youngest to oldest, their entitlements as of the period the transition begins are as follows. The retiree will receive during that period the $40 benefit to which he or she is entitled by $40 of tax contributions made during his or her working life. Worker 4 has accumulated a $30 retirement claim, worker 3, a $20 claim, and so on.

Perceived gains and losses from the phase-out may depend critically on how these residual entitlements are financed. For example, suppose we continue to collect payroll taxes as long as benefits are being paid. The payroll tax will be phased out in coordination with the benefit phase-out. Worker 4 unambiguously loses. His or her tax obligation during the last working period is unchanged compared to what it would have been if the program had continued, but that tax payment no longer adds anything to retirement income. What about worker 3? During the remaining two periods of his or her working career, tax payments are $10 and $7.50 respectively. A tax saving of $2.50 in the second period is accompanied by a $20 reduction in government-provided retirement income. The market interest rate would have to be at least 800 percent for worker 3 to avoid losing from the phase-out. We could go through similar computations for all current voters. It is entirely possible in this simple example that even though everyone is harmed by the existence of the government program in the sense that their tax obligations could be put to better use, a tax-financed phase-out that guarantees existing entitlements could do even more harm to many or all current voters at the time of implementation. Future workers would reap the benefits.

The Ferrara plan would abolish the payroll tax immediately and finance residual entitlements out of general revenues. This procedure would redistribute the tax burden within each generation as compared to the distribution arising from financing out of payroll taxes, but it is important to note that the tax distribution across generations may not change significantly. Taxes that are imposed to finance entitlements are still phased out at the same rate at which benefits are reduced. Well-informed voters may therefore find financing out of general revenues as unattractive as financing out of payroll taxes. In reality, voters tend not to be very well informed. This may lend some appeal to financing out of general revenues from a political (albeit not an ethical) perspective. Burying the costs (in the form of taxes) of financing residual entitlements in general revenue rather than making such costs explicit by continuing to rely on an earmarked tax may serve to disguise these costs. Poorly informed voters may be

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led as a consequence to support a proposal that well-informed voters would oppose.

Financing through bonds is an alternative approach to making the transition to a fully funded pension system. This issue has been discussed by Professor Buchanan,[4] and I will only briefly summarize the argument. The problem with financing through taxes, in terms of its failure to appeal to current voters, is that those voters end up paying twice: once for the pensions of their elders and again for their own pensions. Despite the higher rate of return to be earned with private investment, the tax phase-out does not provide capital early enough for voters to invest and come out ahead in comparison to the pay-as-you-go system. If one accepts the Buchanan model of public debt, financing through bonds can be used to shift part of the tax burden of financing residual entitlements onto future generations of taxpayers. There is an ethical justification for this, since future generations will also reap substantial benefits from eliminating the pay-as-you-go system.

My concluding comment on the political feasibility of privatizing Social Security along the lines supported by Butler and Germanis is that they need to give more careful consideration to the alternative financing options. I doubt that expanding IRAs will be enough to attract political support for their plan. Certainly they have not supported that hypothesis in any analytical sense. Some careful calculations of gains and losses under various financing schemes would be helpful.

Let me now turn to another issue that has arisen periodically in the debate over Social Security reform. Mancur Olson, Joseph Pechman, and Rudolph Penner have presented a direct challenge to the proposition that a funded private pension system is inherently preferable to a pay-as-you-go government program.[5] Their argument has two components. First, they argue that intergenerational transfers are an efficient means of providing for old age. A pay-as-you-go transfer from young to old is in line with a long and worthy tradition of children supporting their aged parents. Second, there may be some inherent advantages in collectivizing this function. We can assure individuals who do not have children or whose children predecease them that they will be provided for nonetheless. Many individuals may feel that their retirement income is more secure if provided

[4]James M. Buchanan, Comment in *Financing Social Security*, Colin D. Campbell, ed. (Washington, D.C.: American Enterprise Institute, 1979), pp. 208–12; idem, "Social Security Survival: A Public-Choice Perspective," *Cato Journal* 3 (Fall 1983): 339–53.
[5]See their comments in the *Cato Journal* 3 (Fall 1983).

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through a formal government program rather than as a consequence of an implicit and unenforceable contract with their children, and so on.

This argument cannot be rejected out of hand. It is reasonably plausible, at least on the surface. However, there are some interesting issues here that need further analysis. Let me suggest two of these. First, it appears that there are some fundamental changes in people's attitudes and behavior that occur when an intrafamily activity such as income support for the elderly is collectivized. Because of this, government transfer program may not very much resemble the private process that it replaces. For example, if transfers to aged parents were purely a family decision, I doubt that those among today's elderly who have accumulated significant wealth would be willing to ask their children for a significant portion of their income. Yet these same individuals seemingly have no qualms about using their political clout to demand through Social Security what is, in an objective sense, the same thing.

My discussion of this issue is admittedly ad hoc. Perhaps careful empirical analysis will fail to support my hypothesis that this change in attitudes occurs. This is a legitimate and important research issue. Certainly, better information would be helpful in assessing the desirability of privatizing Social Security.

There is a second potential difference between a private and a collectivized intergenerational transfer that also seems worthy of some research attention. In a private system, parents have an obvious incentive to invest in the human capital of their children. A collectivized system introduces a divergence between the private and social returns to investment in the human capital of the younger generation. With a public pension program, whether a couple has children or not or how heavily they invest in the future earning capability of their children may have an insignificant effect on their potential retirement income. Even if many parents continue to receive some marginal contributions from their children, the income effect of the public pension program can be important. If all couples respond to this change in incentives, however, the potential return from the public transfer program may be sharply reduced in comparison to the average return received with a system of intrafamily transfers from young to old. Birth rates may fall and the quantity and quality of human capital investment may decline. Finally, arguments for collectivizing an activity are often based on the existence of a severe free-rider problem in a private, voluntary setting. It appears, however, that in the case of Social Security, government provision itself introduces a free-rider problem that would not exist in the voluntary setting.

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PRIVATE ALTERNATIVES TO SOCIAL SECURITY: THE EXPERIENCE OF OTHER COUNTRIES

John C. Goodman

Introduction

When the Greenspan Commission on Social Security Reform took up its historic mission, the nation faced two major Social Security problems, a short-run problem and a long-run problem. The short-run problem was relatively easy to define. The Commission estimated that we would need an additional $150 billion to $200 billion over the next six years to pay for benefits that had already been promised. So in a general sense, the solution to the short-run deficit was dictated even before the Commission began its work: Somehow the government would have to raise $150 billion to $200 billion in additional taxes.

Like the short-run problem, the long-run problem of Social Security was also a financial one. But the long-run problem was much more severe. Under the "pessimistic" assumptions adopted by the Social Security Administration, we faced the strong possibility that 70 years from now between 40 and 50 percent of all taxable payroll would be needed to pay for the package of benefits that had been legislated into law.[1]

Now, extracting *half* of every payroll to support Social Security is a frightening prospect. There are two things that should make us view this projection seriously. First, the "pessimistic" assumptions used for short-run predictions in the past have tended to be much closer to reality than the "intermediate" assumptions of the Social Security Administration. Second, the "pessimistic" projection of the

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The author is president of the National Center for Policy Analysis and is associate professor of economics, University of Dallas, Irving, Tex. 75061.

[1]See A. Haeworth Robertson, *The Coming Revolution in Social Security* (McLean, Va.: Security Press, 1981), p. 90.

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Social Security Administration is by no means the worst thing that could happen. Who could have imagined 70 years ago that today we would have virtually eliminated polio, measles, and diphtheria—or that today at least half of all children with leukemia can be saved.

In a similar vein, what would happen if over the next 70 years a radical breakthrough occurred that drastically slowed the aging process and expanded the length of retirement, without correspondingly changing the number of years over which a person could engage in useful work? The result would probably be that in the next century, instead of having two workers for every retiree, we might have one worker supporting two retirees, or even three, four, or seven retirees. Such a development would not only be economically disastrous for the country, it would threaten the very political and social fabric of our nation.

I have always considered it ironic that the possibility of finding a cure for cancer and many other diseases—developments that would prevent death and prolong life—are cast in a negative light for the purposes of social welfare planning. Developments that most of us would consider optimistic, the Social Security Administration regards as pessimistic.

The long-run problem of Social Security, then, is much more than a matter of money. The real long-run problem is that we are placing future generations at great risk. It is much more than an economic problem. It is a moral problem. And it revolves around the question of whether we have the right to impose this risk on future generations—to mortgage the future of our children in this way.

The term "future generations" is abstract, but we must realize that children entering the first grade today will be alive and drawing Social Security 70 years from now. So when we talk about how the Social Security Administration will affect "future generations," we are talking about real people—the sons and daughters and grandchildren of everyone who is alive today.

Because the long-run situation is so serious, it is extremely important that in dealing with the short-run deficit we adopt solutions that deal effectively with the long-run problem. The argument of this paper is that the reforms adopted by the Greenspan Commission will aggravate the long-run problem, making it worse than it otherwise would have been.

Recent Reforms

To repeat, the basic problem faced by the Greenspan Commission and by Congress in the short run was that of raising $150 billion to

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$200 billion in additional taxes. The Commission approached this task from two angles: first, by increasing the payroll tax; second, by increasing the number of people who pay it.

Prior to the 1983 reforms, about 5 percent of the labor force worked for an employer who was not legally covered by Social Security. Another 20 percent worked for an employer who had the option of either remaining in the Social Security system or opting out. These employers were primarily nonprofit institutions, and state and local governments. Among the latter group, about 5 percent of the labor force worked for an employer who had exercised the option of staying out. In addition, a growing number of eligible employers were exercising their right to opt out of the system. Between 1980 and 1982, for example, there were more than 1,150 applications to opt out submitted to the Social Security Administration; 412 were from state and local governments.

Thus, in the United States, we faced the real possibility that as many as 25 percent of all workers were going to opt out of Social Security. On the negative side, such opting out does create a short-run problem in the sense that we would have 25 percent fewer taxpayers. But on the positive side, we would ultimately have 25 percent fewer beneficiaries, which would have mitigated the long-run problem.

The solutions proposed by the Greenspan Commission, and adopted by Congress, are designed to force these people back into the system. At the end of this year, all nonprofit institutions will be forced to become a part of the Social Security system. Furthermore, the reforms will put a halt to the exodus of state and local governments from the system and will require all new federal employees to join the system. While it is true that these reforms will give us more tax dollars now, it is also true that they will worsen the problem in the future, when there will be a correspondingly higher number of retirees who will be drawing benefits. Seventy years from now, the amount of money needed to pay benefits will be about 25 percent higher because of the 1983 reform legislation.

It is important to note that the problem we face in the United States is no different from the problem facing every other developed country. The long-term problem of solvency in Social Security stems from an inherent flaw in any pay-as-you-go pension system. This system is characteristic of virtually every developed nation in the world, and the only way to eliminate or reduce the problem is to eliminate the pay-as-you-go feature, or reduce it as much as possible.

There are governments in the world today that have taken major steps in this direction. Britain is one; Chile is another. Both of these

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nations have acted responsibly and rationally to assure that current retirees will continue to receive their full benefits; but at the same time they have greatly reduced the long-term liability of their Social Security systems. In both cases, these countries took steps in the exact opposite direction from those recently taken by the U.S. Congress. They acted to solve their long-term problem *not* by forcing more workers into the system, but by going to great lengths to encourage workers to opt out.

Now if it were a law of social science that human societies inevitably construct Social Security systems that by their very nature are doomed to failure, then it would be futile for us to worry about the future. It would be a foregone conclusion, not subject to change. But such a development is not inevitable. Indeed, the examples of Britain and Chile provide evidence that policy makers can act responsibly to prevent—or at least greatly diminish—the kind of crisis we face today in the United States.

Contracting Out of Social Security in Great Britain

Britain has had a system of contracting out of Social Security (on and off) since 1960.[2] In many ways, the issue of contracting out has had a history similar to that of the issue of privatizing the steel industry. The Conservative Party favored it. The Labour Party opposed it. And when each party got into office, it put its own program into effect and reversed the policies of the previous government. In 1978, however, Britain launched the most comprehensive contracting-out scheme to date, with the endorsement of both the Conservative and Labour parties. As such it represented a political compromise.

Essentially, Britain has two types of Social Security benefit schemes. One requires mandatory participation, the other is voluntary. The first tier, the mandatory scheme, pays a benefit that is like a minimum income. All workers must pay in, and above a certain earnings level, they receive the same benefits regardless of their earnings and regardless of the amount of taxes they contributed.

The second-tier pension scheme, however, is based on earnings. The more you earn, the greater your pension. Thus, the second tier is comparable to a private pension plan as we know it. In addition, and unlike the first-tier scheme, the second-tier pension is not mandatory. Private companies are granted the option of contracting their

[2]For a more complete description of the British Social Security system, see John Goodman, *Social Security in the United Kingdom: Contracting Out of the System* (Washington, D.C.: American Enterprise Institute, 1981). See also idem, "Lessons from Abroad," *Rebuilding Social Security*, vol. 18 (1982), pp. 23–31.

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employees out of the second-tier benefit program and into a private pension plan. They are allowed to do so only if they provide their workers with a plan that provides benefits as good as or better than the workers would have received had they remained in the state system.

An example of contracting out is shown in table 1. Taxes and benefits are illustrated for a worker who earned the average wage in April of 1978, when the new system was put into effect. If pounds are converted to dollars using the exchange rate of one pound for two dollars, then a worker who has contracted out of the second-tier

TABLE 1

THE CONSEQUENCE OF CONTRACTING OUT FOR A WORKER EARNING THE AVERAGE WAGE IN APRIL 1978

	Full Participation	Contracting Out
Annual income	£4,160.00	£4,160.00
Payroll tax on the first £910	168.35	168.35
Payroll tax on additional income	601.25	373.75
Total payroll tax	£769.60	£542.10
Annual tax reduction for contracting out		£227.50
Annual pension from the state for one year of employment (in 1978 values)		
Basic component	£910.00	£910.00
Additional component [.0125 × (4160 − 910)]	£40.63	-0-
Annual pension from the state for 20 years of employment (in 1978 values)		
Basic component	£910.00	£910.00
Additional component [.25 × (4160 − 910)]	£812.50	-0-

Each year the contracted-out worker gets a tax reduction of £227.50 in return for forgoing the right to draw an annual pension from the government equal to £40.63 per year.

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pension scheme pays about $455 less in taxes each year. In return for this tax reduction, he forgoes an annual pension equal to $81.26. The amount of tax reduction is chosen so that on the average, workers will find it to their financial advantage to contract out of the system.

April 1983 marked the five-year anniversary of the two-tier system, and to date it has been highly successful. Since 1978, more than 45 percent of all British workers have contracted out of the second-tier pension scheme. Moreover, by allowing the option of contracting out, the British government has effectively cut its second-tier pension liability in half. Overall, I estimate the government has reduced its entire Social Security liability by more than 30 percent by adopting the contracting-out system.

It is important to recognize what the British system of contracting out does and does not accomplish. In particular, it does not solve Britain's current short-term Social Security problem. There are a number of pensions-in-payment, and government must raise the revenue to pay for them. So in the short run, the government must have almost as much tax money today as it would have had without the contracting-out scheme. Nevertheless, over the long term, pension payments will be significantly reduced.

Several additional points about the British system should be emphasized. First of all, the choice to contract out is not an individual worker's choice. It is an option granted only to employers. Employers contract their workers out of the second-tier pension system by providing them with an adequate pension. Of course, it is expected that the employers will exercise this option only after consulting with their employees.

Second, private employers cannot contract out some workers and leave others in. That is, they cannot simply remove the workers who are most favorably affected by the new scheme while leaving all other workers in the state pension system.

Third, the same tax reduction is given to all workers regardless of age and income level. Table 2 illustrates the importance of this condition. The table shows the present value of full participation in the British Social Security system for workers at different age and income levels. For example, a single, male worker who is 20 years old and earning the maximum taxable income of £6,240 per year has a present value in Social Security of −£22,423. Simply put, his stake in the system is negative. On the other hand, a 50-year-old worker who is fully participating in the system and who is making a minimum income of £910 per year has a present value in Social Security equal to about £5,618. Thus, as the table illustrates, British workers at

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TABLE 2

NET SOCIAL SECURITY WEALTH (IN POUNDS) FOR FULLY PARTICIPATING MALES, BY AGE AND WAGE LEVEL

Weekly Wage (£)	Age 20	30	40	50
17.5	−8,219	−68	2,330	5,618
20	−9,722	−512	1,534	3,972
30	−15,738	−2,284	587	3,577
40	−19,512	−4,057	−360	3,183
50	−20,680	−5,829	−1,307	2,789
60	−21,297	−7,602	−2,254	2,395
70	−21,701	−9,374	−3,201	2,001
80	−21,969	−11,147	−4,148	1,607
90	−22,146	−12,919	−5,094	1,213
100	−22,281	−14,347	−6,041	819
110	−22,352	−14,828	−6,988	425
120	−22,423	−14,987	−7,752	12

Note: Figures are for a real rate of growth of income of 1.75 percent and a real interest rate of 3 percent.

different age and income levels are affected in different ways by the Social Security system.[3]

All workers contract out on the same terms, however. In 1978, workers who were fully participating in Social Security paid a payroll tax of 18.5 percent. Workers who had contracted out paid a payroll tax of 11.5 percent, so the tax reduction for contracting out was 7 percentage points. Elderly workers have less to gain by contracting out, for two reasons. First, they have a longer life expectancy and therefore can expect to draw more monthly benefit checks than younger workers. In addition, they have fewer taxpaying years left. So contracting out is less appealing to an older worker than it is to a younger worker.

It turns out that the amount of tax reduction necessary to encourage a 20-year-old male worker to voluntarily contract out of the system would be only about 4 percentage points of payroll tax. On the other hand, to get a 50-year-old worker to voluntarily opt out of the system

[3]Similar differences exist in the United States. See Martin Feldstein and Anthony Pellechio, "Social Security Wealth: The Impact of Alternative Inflation Adjustments," in Colin Campbell, ed., *Financing Social Security* (Washington, D.C.: American Enterprise Institute, 1979), pp. 91–117; and Anthony Pellechio and Gordon Goodfellow, "Individual Gains and Losses from Social Security before and after the 1983 Amendments," *Cato Journal* 3 (Fall 1983): 417–42.

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would require a difference of about 8.6 percentage points. Because the terms of contracting out treat all workers the same, and give all workers only a 7-percentage-point tax reduction, it is necessary to do contracting out on a group basis so that the companies that choose this option will have some young workers, some old workers, some male workers, and some female workers.

One way to understand the British system is to compare it with something that we have allowed to happen in the United States: the practice of allowing nonprofit corporations to opt out of the system. Baylor University Medical Center in Dallas, for example, is a huge medical complex that employs about 6,000 people. In the fall of 1982, they opted out of the Social Security system. The retirement plan that Baylor adopted was an "integrated plan," which means that it is integrated with the current Social Security system.

In essence, what the Baylor plan does is to establish for each worker a target level of retirement income, typically about 60 or 65 percent of preretirement income. The private plan pays survival and disability benefits not paid by the Social Security system. If the employee is entitled to Medicare benefits, then he receives them. If not, then the Baylor plan pays the fee necessary to enroll the employee in the Medicare program. Baylor University Medical Center calculated that in order to fund its private plan, it needed a total payroll tax of only 8.4 percent. Compare that to the 13.4 percent of payroll tax imposed by the Social Security system. Baylor calculated that over the next 10 years, it and its employees would save $92 million by opting out of Social Security.

There are two basic differences between what the Baylor Medical Center was allowed to do and what happens in Britain. First, in Britain you can opt out of only the retirement part of Social Security. You cannot opt out of other social insurance programs, such as National Health Insurance. This difference, however, is a minor one. The major difference is that under the U.S. system we have allowed an entity like Baylor Medical Center to retain $92 million as a result of opting out. In Britain the tax reduction given to companies that contract workers out is geared to be just enough to encourage opting out, but no more than that. So, for example, if we were applying the British example to Baylor Medical Center, we would not want to give away $92 million. Instead of allowing Baylor Medical Center to pay no payroll taxes as a result of opting out, we might set its payroll tax at about 5 percent. In this way, Baylor employees would still be paying something into the Social Security system, but their tax reduction would still be sufficient to encourage opting out.

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I believe the Greenspan Commission should have proposed a plan similar to Great Britain's. If it had done so, it would have proposed continuing to encourage nonprofit institutions and state and local governments to opt out of the system, but it would have imposed an additional tax on them. In this way, the Social Security system would have received additional revenues in the short run, but would not have taken on the additional liability of having to pay more pensions to these workers in the long run.

Opting Out of Social Security in Chile

Chile adopted a system of opting out of Social Security in May of 1981. Unlike Britain, however, the Chilean scheme is an individual choice, not a company choice. Individuals are allowed to opt out of Social Security by putting at least 10 percent of their income into the Chilean equivalent of an Individual Retirement Account. The IRA is managed by private companies, such as insurance companies, banks, or other thrift institutions. As in the United States, there is competition among these institutions for the IRAs. At the same time, there are some restrictions on what kinds of investments the institutions can make with their clients' money.

The payroll-tax reduction for opting out of Social Security in Chile is 10 percentage points of income. If you remain in the system, you pay a payroll tax of 27 percent; if you opt out, the tax is reduced to 17 percent. So the 10 percent income saved by "opting out" is theoretically the 10 percent transferred into an IRA. Finally, all new workers in Chile are kept out of the state-run Social Security system and are required to open up their own IRAs.

For Chilean workers who had been under the state system in the past and choose to opt out, the government gives them nontransferable bonds to cover their past contributions to the system. These bonds can be redeemed when the worker retires. At the retirement age, which is 65 for men and 60 for women, the worker may use the funds in one of several ways. For example, the worker can take a series of programed withdrawals over time from the account, or can purchase an annuity with funds from the account. In the former instance, any money not spent by the retiree will belong to his or her estate. The only requirement is that a worker must leave enough in his account to guarantee him the minimum pension guaranteed by the government, which in 1981 was about $100 per month.

The system has been enormously successful. Between May and December of 1981, almost 50 percent of all Chilean workers had exercised the option to be out of the state-run system.

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Principles of Contracting Out

If we are to adopt a system of allowing either contracting out of Social Security by companies or of opting out of Social Security on an individual basis, there are two political realities that cannot be ignored. First and foremost is that current retirees must be paid the benefits they have been promised.

Benefits received by Social Security retirees are essentially dictated by a delicate political equilibrium. There is a natural political tension between the young and the old because we are in a pay-as-you-go system, and taxes paid in by the young are paid out in the form of benefits to the old. In order for the retirees to have greater benefits, higher taxes must be placed on young workers. Conversely, any proposal that drastically reduces promised benefits to current retirees is likely to be rejected.

The second political reality is that the choice to contract or to opt out must be voluntary. It must be perceived that workers are given a choice. If you opt out of the system, you get a tax reduction. In return for that tax reduction, you forgo certain claims against the Social Security system. On the other hand, if you want to stay in, you pay a higher payroll tax. Workers must be given the choice of staying in the system, but they must understand that their choice means that payroll taxes are going to be higher than they are today. These two political realities dictate the structure of contracting out of the scheme.

And finally, any new system must have two structural components: First, since benefit payments to current retirees cannot be changed, we must collect enough in taxes now to pay those obligations. In other words, the total amount of payroll taxes collected under a new system must equal what it was under the old system in the short run. Second, there must be a differential payroll tax. Those who remain in the system must pay higher payroll taxes than those who opt out. After all, it is the differential payroll tax that gives people the incentive to opt out.

It is worth noting that the differential payroll tax has to be larger in the short run than in the long run. When Britain adopted its system in 1978, it needed a payroll-tax reduction of approximately 7 percentage points to encourage companies to opt out of the system. Five years later, in April of this year, Britain was able to reduce that payroll-tax differential to 6.5 percent. In future years they will be able to reduce it even further. And, as I pointed out earlier, for each new generation of workers you need only about a 4-percentage-point reduction in the payroll tax to induce workers to choose the contracting-out alternative.

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Conclusion

To my knowledge, the Greenspan Commission on Social Security Reform did not hear testimony from a single individual describing how contracting out or opting out works in other countries. In fact, this viable alternative to the present system was not even marginally considered.

Yet, contracting or opting out of Social Security is clearly politically practical. The example set by Great Britain, a major industrialized Western nation and a democracy somewhat similar to ours, proves it. Even though Britain is more socialistic than the United States, it adopted radical reforms to reduce its long-run Social Security problems.

Furthermore, Britain's two-tier scheme faced no major opposition and was either endorsed or at least not opposed by the country's major trade unions. Their members had the most to gain by the new system, since it was these workers who (by and large) had the best private pension plans already in existence.

Contracting out or opting out of Social Security also makes a great deal of economic sense. Taxes paid into a pay-as-you-go Social Security scheme primarily finance current consumption. By contrast, contributions made to private pension plans provide additional funds for the private capital market. These additional funds allow increased private investment and stimulate economic growth. We owe it to ourselves to do what the Greenspan Commission did not do, and that is to take a closer look at this alternative.

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BREAKING THE POLITICAL BARRIERS TO PRIVATIZATION

Don Bellante

A point that seems central to almost any discussion of policy options is that what appears to be an economic problem is often much more of a political problem. We have seen an interest develop in the privatization of Social Security that would have been difficult to envision a decade ago. Even if we could take for granted a consensus opinion to the effect that Social Security should have been privately provided from its very beginning, we would expect the political difficulties that would stand in the way of privatization to be formidable.

The genuinely political problem begins with the transitional costs associated with privatizing the system. There is an implicit understanding that privatization is impossible without abandonment of the pay-as-you-go feature of the system, so the two issues are not distinct. Every responsible proposal for conversion to a fully funded system has addressed itself to the transitional problem, the nature of which makes the political barriers to privatization seem immense. Left to my own intuition, I would judge those barriers to be insurmountable, perhaps not even worth a try. But economists are not particularly astute at determining what is or is not politically feasible. How many economists four years ago would have thought it feasible that Congress would index taxes? Hence, to proponents of privatization of Social Security, the fact that Great Britain and Chile have moved in the direction of privatization must be very encouraging. John Goodman has made us aware of some of the details of these moves. He has shown that the acceptance of "opting out" in these two countries demonstrates its political feasibility as far as those two nations are concerned. What should be of greatest concern to advocates of privatization in the United States is whether or not there are lessons to be learned from the British and Chilean experiences, and whether

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The author is professor of economics, Auburn University, Auburn, Ala. 36849.

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or not those lessons can be utilized to advantage in an American effort to privatize.

The Chilean experiment, in its significant features, bears a strong resemblance to Milton Friedman's proposal for reform of the U.S. Social Security system as explained by Ferrara, with the important exception that workers in Chile do have the option of remaining in the Social Security system.[1] It appears that Friedman's influence on economic policy in Chile has been even greater than many of us had realized. A more fundamental distinction between the Chilean program and the Friedman proposal is that in the former a payroll tax continues to be imposed on those workers who opt out. Professor Goodman seems to be implicitly suggesting that workers might be inclined toward indifference between staying in and opting out because the total cost of provision for retirement remains the same either way. Whether or not Professor Goodman intended such an implication, I do think that it is a more or less valid conclusion, but only because of the circumstances that are peculiar to Chile.

Normally, we should expect both current cost differentials and differentials in expected retirement benefits to determine the worker's choice on opting out. But the Chilean case is not normal. The average Chilean faces what must surely be an imponderable problem in trying to guess the form of government he will be living under in the distant future. It will be even more difficult for him to determine the probability that the benefits that will result from remaining within the state system will even remotely resemble their present structure and level. On the other hand, the future state of private property rights under whatever form of government prevails is at least as radically uncertain. With such radical uncertainty, it would not be surprising that Chilean workers would give the appearance of basing their decision on the current cost differential. Since this differential is zero, such workers might just as well decide by the toss of a coin—a decision rule that would yield the same proportion opting out as we now observe doing so.

In short, we do not know whether the rate at which Chilean workers have chosen to opt out provides any indication of what American workers would do. Similarly, the Chilean experience tells us little if anything about the political feasibility of attempts at establishing the option of contracting out in the United States. The simple fact is that Chile is not a democracy, and thus the political constraints are of a wholly different nature.

[1]The Friedman proposal is discussed in Peter J. Ferrara, *Social Security: The Inherent Contradiction* (San Francisco: Cato Institute, 1980), pp. 348–50.

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The case of Great Britain leads to just the opposite conclusion: There are probably many lessons to be learned from the British experience. In the British plan workers whose employers have opted out continue to pay a tax, lower than the tax paid by workers remaining wholly in the system. However, workers whose employers have opted out retain a claim to the mandatory component of the Social Security program. While purists may take a dim view of such political compromises, it is probably just the degree of compromise that made opting out a political possibility in a democratic society similar to ours. In effect, workers were allowed to hedge a bet, and U.S. proponents of opting out should take note. If British workers feel more secure with partial opting out as time goes by, then it will gradually become politically more feasible to move further in the direction of complete opting out. Further, the requirement that employers opting out provide a retirement benefit comparable to what workers could receive from the optional part of Social Security goes as far as is possible in the direction of guaranteeing that workers who opt out will be no worse off at retirement. This feature probably made opting out far more politically feasible than would have been the case under an alternative requirement, i.e., that the contribution be a defined amount with the retirement benefit left uncertain. As appears to be the case from the description provided by Professor Goodman, the bearing of risk is undertaken by employers, or their contractors, who are in a position to better deal with the risks involved.[2]

Professor Goodman has provided us with reasonably complete information about the financial impact on employees of opting out, but we do not have similar information about the impact on employers. Yet we do know that it is employers who have the option, and that employers representing 45 percent of the work force have opted out. For these employers at least, opting out obviously must be financially attractive. But what makes it attractive? We should like to know, for example, whether employers are required to fully fund their obligations, before we reach any conclusions about the desirability of imitating the British system.

There are other important questions for which the information furnished does not provide a basis for formulating answers: How does the existing structure of taxes and retirement benefits, with its provision for opting out, differ from the structure that preceded it?

[2]The shifting of risk bearing between firms and workers is at the base of many of the recent developments in macroeconomic theory. Cf. Costas Azariadis, "Implicit Contracts and Underemployment Equilibria," *Journal of Political Economy* 83 (November/December 1975): 1183–1202.

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The answer to this question would be of use in determining what factors made the reform politically attractive. Did the reform also accomplish the task of changing from an actuarially unsound to a sound program? If the preceding system was more nearly sound, then the attainment of political acceptability for the contracting-out system would be less of a problem.

The problem facing the U.S. system is particularly acute. The actuarial weakness of the existing structure of payroll taxes and benefit obligations makes political acceptance of privatization more difficult, not less difficult as is commonly believed. Among U.S. workers old enough to place more emphasis on the structure of benefits than on the burden of payroll taxes, the acceptance of a private system would be far more likely if they compared it with the benefits that would accrue *on an actuarially sound basis* from the present payroll-tax structure, instead of comparing it with the present, *actuarially unsound* structure of benefits. It is an undeniable fact that the present structure of benefits is not sustainable under the present structure of taxes. Moreover, benefits are probably well in excess of what would result from a fully funded system. This observation highlights the most fundamental aspect of the problem.

Critics of the existing U.S. system emphasize that it mixes a welfare function with an insurance function. What should be emphasized is that 100 percent of the existing system is a welfare program that redistributes income from those who are working to those who are retired. Current retirees are receiving large net gains; and those close to retirement expect a net benefit from the system, while younger workers do not. It is the fact that so many workers currently expect to be net gainers that explains much of the opposition to privatization. Only when most workers are disposed to see the chain-letter effect of the pay-as-you-go system as harmful to their long-run interests will political resistance to privatization be reduced to manageable proportions.

One of the most intriguing facts related to the British provision for opting out is that this reform was instituted under a Labour government. As Professor Goodman points out, unions either supported or ignored the move toward allowing workers to opt out. He also points out that in the past, the Labour party opposed the permitting of opting out. Why did the labor movement of Great Britain act as it did? Why the change of heart? Something about the current program must have been more attractive to the unions than was true of prior opting-out programs, and we should want to know precisely what has "sweetened the deal." We sometimes automatically tend to think of unions, particularly British unions, as favoring anything that strengthens the

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hold of government over society's resources. But this knee-jerk reaction ignores the likelihood that unions will prefer union control of resources to government control. Recognition of this point suggests that the opting-out program of Great Britain presents increased opportunities for such union control.

Unions in Great Britain have a great deal more influence over the investment of funds than unions in the United States. And it is surely no coincidence that the current program was being promoted in Parliament at about the same time that the Labour government's minister of state for Social Security was proposing a bill that would legally require at least 50 percent representation by trade unions on the controlling bodies of all occupational pension programs.[3] Although the provision for opting out did get through, any chances of passing the minister's bill expired when Labour's control of Parliament expired. But this knowledge of the political horizon as it appeared in the late 1970s may go a long way toward explaining the stance of the unions and their political party. One conclusion to be drawn is that political acceptance of privatization in the United States will require that organized labor see gains from privatization. The provision of some union role in the management of pension plans of organized firms is the most obvious such gain, although an extreme move such as was attempted in Great Britain would probably not be necessary.

The provision of a union role in the management of pension funds may be too high a price to pay for privatization. For the last several years the American labor movement has heavily promoted legislation favoring union control of pension funds, and the advocates of union control have stated quite emphatically that their motives go well beyond the assurance of safety of and return on investments. The movement has been viewed with alarm in some quarters, but I have argued elsewhere that a union role in pension-fund management, even if it operates perversely, will have its strongest effects on union members.[4] In other words, any significant negative effects are likely to be internalized. Union members may wish to take the matter into consideration, but the rest of society probably need not do so. In any event, the extent of unionization of the U.S. labor force is less than half of what it is in Great Britain, and so union support, or nonsupport, of privatization is not likely to be as consequential in the United States as it must have been in Great Britain.

[3]Paul Johnson, "Unions, Pensions, and Financial Responsibility: The British Experience," *Journal of Labor Research* 2 (Fall 1981): 289–98.

[4]Don Bellante, "Union Divergent Investing of Pensions: Comment," *Journal of Labor Research* 2 (Fall 1981): 209–13.

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Overall, I am compelled to agree with all of Professor Goodman's conclusions. If privatization is politically feasible in Great Britain, it is politically feasible here. The failure of the Greenspan Commission to give even the slightest consideration to any degree of privatization is inexcusable. The advocates of privatization thus have a lot of work to do, but the knowledge of what Great Britain has accomplished should encourage them in their efforts.

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FUNDED SOCIAL SECURITY: COLLECTIVE AND PRIVATE OPTIONS

Richard E. Wagner

The present Social Security program bears some resemblance to an insurance program in that there is some positive, though weak, correlation between the taxes people pay and the benefits they receive. However, Social Security's vast network of transfers, in conjunction with the absence of any contractual relationship between participants and the government, also gives it many of the characteristics of a welfare program. For instance, one study of implicit rates of return on Social Security taxes found that people in the lowest quartile of lifetime earnings received three times more from Social Security per dollar of tax they paid, than did people in the highest quartile of lifetime earnings.[1] By now various scholars have pointed to the simultaneous existence of insurance and welfare elements within the Social Security program as the pivotal source of the difficulties that have increasingly come to plague the program. One of those scholars, Peter Ferrara, has referred to this confounding of insurance and welfare as Social Security's "inherent contradiction."[2]

When Social Security is diagnosed as suffering from programmatic schizophrenia, remedy clearly seems to require some separation into two programs—one to address the insurance element and the other to address the welfare element. This approach to diagnosis and remedy reflects a long-standing approach to problems of public policy in economics. The seminal articulation of this approach was presented

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The author is professor of economics and policy sciences, Florida State University, Tallahassee, Fla. 32306.

[1]Alan Frieden, Dean Leimer, and Ronald Hoffman, *Internal Rates of Return to Retired Worker-Only Beneficiaries under Social Security, 1967–70*, Studies in Income Distribution, no. 5 (Washington, D.C.: Social Security Administration, October 1976), p. 17.

[2]Peter J. Ferrara, *Social Security: The Inherent Contradiction* (Washington, D.C.: Cato Institute, 1980). The same theme is pursued further in Ferrara's book, *Social Security: Averting the Crisis* (Washington, D.C.: Cato Institute, 1982).

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by Jan Tinbergen, who argued that first the goals of policy must be selected and then different instruments or policies must be designed to achieve each of the chosen goals.[3] Although I am not a partisan of this approach to policy analysis (in part because the goals/instruments framework gives a misleadingly simplistic view of the processes of policy formation and implementation), I do nonetheless think that the distinction between insurance and welfare elements is useful for thinking both about present difficulties with Social Security and about possible approaches to remedy. My task in this essay is to explore some of the central properties of collective and private alternatives for the provision of retirement insurance. I do this under the presumption that it is sensible to distinguish between the provision of retirement insurance and the provision of welfare, so that questions about the former can be treated independently from questions about the latter.

Funding versus Pay-As-You-Go in Social Security

The economic theory of Social Security draws a central distinction between a pay-as-you-go system and a funded system. A funded system is one in which a person's contribution during his working years is placed in an investment fund. Upon his retirement, that person's contributions, plus accumulated interest, are converted into an annuity. What a person receives during retirement, then, depends upon the amount he contributed during his working years and the interest that those contributions earned. In contrast, a pay-as-you-go system is one in which a working person's tax payments are not invested but are paid out to retirees. What a retiree receives, then, does not depend upon the taxes he paid during his working years but rather depends upon the taxes that are paid by people who are presently working.

It is now becoming increasingly widely recognized that a funded system can, on a sustainable basis, offer people a considerably higher rate of return on their payments than they could receive from a pay-as-you-go system. Under a mature pay-as-you-go system, retirees can receive an implicit return on their earlier tax payments that is equal to the rate of growth in the tax base, which in turn is the sum of the

[3]Jan Tinbergen, *On the Theory of Economic Policy* (Amsterdam: North-Holland, 1952). The tacit assumption of benevolent despotism that informs this common approach to economic policy is certainly questionable under contemporary democratic regimes. For an effort to approach public policy within the explicit context of a democratic regime, see Bruno S. Frey, "Eine Theorie demokratischer Wirtschaftspolitik," *Kyklos* (1978):208–34.

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rate of growth in the labor force and the rate of growth in real wages per worker.[4] Historically, this potential rate of return has been in the vicinity of 3 percent, although this rate may be lower in the future. For one thing, declining fertility rates portend a slower rate of growth in the labor force. They may even portend an actual decline; this will happen if the fertility rate continues below the replacement rate without being offset by immigration. In addition, the slowing in the rate of growth of real income that has occurred over the past decade or so may continue into the future.

With a funded system, the rate of return that participants can receive depends on the yield from investment. Historically, this has run in the range of 10 to 12 percent before tax. Hence, a funded system would seem to be three or four times better than a pay-as-you-go system. However, retirees could not actually receive this superior return (at least at present), because the yield on saving is taxed. Although the rate at which saving is taxed depends on the circumstances of individual savers, a rate in the general vicinity of 75 percent is not uncommon. Saving that is invested in business enterprise, for instance, is taxed in at least three ways: through the local property tax and through federal and state taxes on both corporate and personal income. Per $100 of income from saving, local property taxes can easily amount to $20. Of the $80 that remains, federal and state corporate taxes can easily claim $30. And of the $50 that then remains, federal and state personal income taxes can easily claim $25, thus leaving $25 of the original $100.

A rate of tax in the vicinity of 75 percent places the post-tax yield on saving in the same range as what a mature pay-as-you-go system would yield. But even if retirees receive the same return under either system, the funded system is still superior socially, because the added tax revenues represent a gain to the nonretired citizenry, as these people would have to bear less of a tax burden to finance government than they would under a pay-as-you-go system. Or alternatively, by eliminating the taxation of saving—thereby treating saving and consumption equally—the nonretired citizenry will be treated identically under the two systems and retirees will receive a higher return under funding.[5]

[4]"Implicit" is attached to "return" because the return does not represent the yield on capital assets, as it does in normal usage. Indeed, there is an implicit return even though the effect of the pay-as-you-go system is to destroy capital and income.

[5]Relatedly, a pay-as-you-go system of Social Security seems to have a substantial negative impact on saving and capital formation. What workers contribute under a funded system is saved, but the taxes they pay under a pay-as-you-go system are transferred to retirees, to finance their consumption. As a first approximation, the amount of taxes collected under a pay-as-you-go system of Social Security represents the amount of

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Despite the considerable superiority of a funded system, the present pay-as-you-go system has enjoyed great popularity to date.[6] In part this might be attributed to the high taxation of private saving that strongly restricts the ability of people to get the substantially higher returns their saving produces. But the dominant reason for Social Security's popularity is surely the consequence of its very immaturity. In the early years of a pay-as-you-go system, retirees get high returns with low taxes. As late as 1947, the maximum yearly tax that could be extracted from someone was $60, so it is no wonder that implicit rates of return could exceed 1,000 percent for some people. Those large returns were made possible because retirees paid little tax and the tax base was growing rapidly due to increasing tax rates and extensions in the number of people covered by the tax. Until 1983, the United States was in the initial phase of its pay-as-you-go system: Present retirees spent less than a full working life paying taxes and had the advantage of being retired while the grasp of the tax was continually widened and its rate continually increased.

We are only now starting to enter the mature phase of our pay-as-you-go system. Only now will there start being significant numbers of people retiring who have spent their entire working lives paying Social Security taxes. And another generation must pass before we will be fully into a mature pay-as-you-go system, at which time the predominant number of retirees will have spent their working lives under the system, will have done so at relatively high rates of tax, and will not be able to gain from expansions in the number of people covered by the tax. Some projections of Social Security tax rates see those rates in the vicinity of 40 percent within half a century.[7] The point of such projections is not, of course, that such rates will actually

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additional saving that would have been forthcoming under a funded system. This additional saving would have increased the capital stock, which in turn would have increased productivity and income.

Martin Feldstein has estimated that the reduction in saving and capital formation due to the pay-as-you-go system of Social Security has reduced real income by about 15 percent. His seminal work here is "Social Security, Induced Retirement, and Aggregate Capital Accumulation," *Journal of Political Economy* 82 (September/October 1974):905–26. Although Feldstein's estimate has generated much controversy, this controversy has come to center more on the particular empirical magnitudes (which of necessity are constructions in conjectural history) than on the qualitative point that a pay-as-you-go system entails some reduction in saving and capital formation as compared with a funded system.

[6]For an examination of possible sources of this popularity, see William C. Mitchell, *The Popularity of Social Security: A Paradox in Public Choice* (Washington, D.C.: American Enterprise Institute, 1977).

[7]See the projections presented in A. Haeworth Robertson, *The Coming Revolution in Social Security* (Reston, Va.: Reston Publishing Co., 1981), p. 51.

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come to pass, but that the present course of Social Security cannot be maintained, precisely because those rates of tax are exceedingly unlikely to be tolerated by even the most quiescent of taxpayers at that time.

What will replace the present system, obviously, remains to be seen. A funded system is clearly superior, for as a sustainable system it offers returns that are several times higher than a pay-as-you-go system can offer. But suppose the retirement component of Social Security were to be placed on a funded basis. How would a governmentally operated system of funded retirement insurance compare with the provison of such insurance through a network of competitive, private suppliers? There are, of course, various questions that would have to be addressed concerning the transition from the present to a funded system. The specific way this might be done is not of central importance in comparing governmental and private alternatives. To some extent the unfunded liability might be reduced by such reductions in anticipated future payments as increasing the retirement age and shifting the basis for indexing benefits from wages to prices. What remains of the unfunded liability could be treated as an explicit government debt, with that amount accordingly borrowed by the government and transferred to the Social Security fund. From then on, Social Security would be operated on a funded basis, with retirees living off their own contributions plus interest. But my central task here is not to consider how the transition from pay-as-you-go to funding might take place; rather it is to compare government funding with private provision, under the presumption that the transition can be made in one way or another.

What Rules for Governing a Funded System?

It would always be possible to conceive of a funded program of Social Security operated by government as simply one among many such programs, with all of those programs operating under the same legal rules. Government would simply be one among many competing suppliers of retirement annuities, and people would be able to choose whichever supplier they preferred. Moreover, there would be neither tax provisions nor regulatory requirements that pertained to the private suppliers but not to the government's program. Principles of legal liability and residual claimancy would pertain equally to the government's program and to the private programs.

But as long as government is regarded as a maker of law for others rather than as being simply one participant in a system of law that itself is made by other, consensual processes, it is inconceivable that

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a funded system operated by government would truly be grounded in principles of property and contract.[8] This is certainly the central point to be inferred from the 1960 ruling of the Supreme Court in *Flemming* v. *Nestor*.[9] In the spirit of *Flemming*, people would not have rights of property and contract that they could enforce against congressional infringement. A person could not, for instance, bring an action against Congress on the grounds that it was mismanaging the plaintiff's assets, with evidence on this point being the significantly higher return that those assets could have earned by having been invested in some random sample of private funds. Similarly, Congress would have the ability to create rules that would place private competitors at various disadvantages, not the least of which would be a requirement that everyone make at least some minimum investment with the government fund. I take it for granted, then, that if the government operates a funded system of Social Security, that fund will have some monopoly status and most definitely will not be simply one among many funds all competing under principles of legal equality.

Should government undertake to institute and operate a funded system of Social Security, the performance characteristics of that system would depend upon the type of rules under which that system would be constituted. There are several obvious types of problems with which a funded system operated by government would have to deal, in one way or another. A funded system would be a product of legislation and would be operated by some government bureau. Accordingly, a funded system would confront various problems of legislation and administration, many of which have come increasingly to be elucidated upon in the recently developing literature on the economics of legislation and bureaucracy.

Incentives for Capital Dissipation

The present system of Social Security was, of course, chosen by Congress, and Congress could have chosen to establish a funded system instead. Indeed, Social Security began essentially as a funded system. Moreover, the legislation that established the Social Security program came quite close to allowing people to contract out of Social Security. The original Senate version allowed people to contract out, but the House version did not, and contracting out died in the

[8]On different social processes for the production of law, see Bruno S. Leoni, *Freedom and the Law* (Los Angeles: Nash Publishing Co., 1961).
[9]363 U.S. 603.

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conference committee.[10] Any such provision for contracting out would have constrained the funded nature of Social Security still further, for otherwise the government's program could not have survived in the presence of a provision for contracting out.

However, by 1939 Congress began to dissipate the fund that had been accumulating, by increasing the benefit payments that were made to people who had contributed practically nothing to the fund. There seems to be little basis at present for being optimistic that Congress might choose to create a funded system of Social Security. There is perhaps even less basis for being optimistic that such a system, once created, would be operated and maintained as a truly funded system. The modus operandi of a funded system seems to run counter to the known proclivities of legislatures to spend all that is available to them, and then some.

Suppose a funded system were established in, say, 1985. What would prevent this system from being converted to a pay-as-you-go system by, say, 1992, through amending legislation of the 102d Congress? The arousal of temptations for capital dissipation in the face of an accumulating fund is an inherent feature of prevailing political institutions, in which government is not itself subject to rights of property and contract but rather is able to continually act as an abridger of those rights through its powers of taxation and regulation. Whether a future Congress would choose to replace the choice of a previous Congress to put Social Security on a funded basis, by shifting to a pay-as-you-go basis, depends on the array of political forces at that future date.[11]

Imagine a situation a few years after a previous Congress had placed Social Security upon a funded basis, and consider how a proposal to shift to a pay-as-you-go basis would affect different people. For people who are already retired, the change would offer increased benefit without cost. Those people would receive more than their own contributions plus interest, because they would also receive some support from the tax payments of current workers, but they would not be liable for tax. People close to retirement will bear some cost through higher taxes but will gain even more through participating in the dissipation of the fund. As age declines, a break-even point will be reached, after which the gains from participating

[10]For this bit of history, as well as a thorough treatment of the overall development of Social Security, see Carolyn L. Weaver, *The Crisis in Social Security: Economic and Political Origins* (Durham, N.C.: Duke University Press, 1982).

[11]See the discussion of this general point in Edgar K. Browning, "Why the Social Insurance Budget Is Too Large in a Democracy," *Economic Inquiry* 13 (September 1975): 373–87.

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in the fund's dissipation will be outweighed by the losses incurred through higher taxes and less future income.

In a setting in which one-third or so of the adult population is retired, it would not take the support of too many additional people to constitute a majority. This is reinforced by the higher rate of voting among the retired: More than two-thirds of those above age 65 voted in the 1980 general election, while the overall voting rate was just over 50 percent. Hence, there is certainly no basis for thinking that just because one Congress places Social Security on a funded basis, subsequent Congresses will continue with that choice. Unless people have enforceable claims to their own contributions, a switch to a pay-as-you-go basis is likely to prove irresistible eventually, because it would offer gains to a dominant subset of the citizenry.

Even if one Congress does establish funding as a basis for Social Security, subsequent Congresses are not bound to maintain that basis. Consequently, any effort to institute a governmentally operated system of funding will require some means of preventing subsequent dissipation of that fund. But since one Congress cannot bind its successors, and since it is inconceivable that the government fund would be operated as simply one fund among many under a general rule of law, the ability of some subsequent Congress to dip into the fund could be foreclosed only by giving the fund some type of constitutional standing. There has, of course, been a growing interest in inherent legislative biases toward spending and toward shifting burdens from the present to the future through deficit financing, as well as possible constitutional constraints to limit those biases.[12] There has also been a growing recognition that legislatures can be truly creative in evading the intent of those constraints; for instance, much of the growth of off-budget activity by state governments has been a response to balanced-budget requirements.[13]

What Rules for Managerial Conduct?

Even if it were possible to develop rules, constitutional or otherwise, that would prevent subsequent capital dissipation, a further consideration arises concerning the efficiency with which the funded system would be operated. The return that a funded system, as well

[12]On balanced-budget requirements as a possible constraint on the proclivity of legislatures to mortgage the future for present gain, see James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (New York: Academic Press, 1977); and Robert D. Tollison and Richard E. Wagner, *Balanced Budgets, Fiscal Responsibility, and the Constitution* (Washington, D.C.: Cato Institute, 1980).

[13]This subject is examined in James T. Bennett and Thomas J. DiLorenzo, *Underground Government: The Off-Budget Public Sector* (Washington, D.C.: Cato Institute, 1983).

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as a private alternative, will yield will obviously depend on the performance of the assets that the fund owns. Various investment funds differ in their rates of return over any particular period. Some of this variation is surely due to variation in managerial quality and performance. Market processes of competition in the context of residual claimancy generally promote the replacement of poorer management with better management. This takes place either directly, through the actual replacement of one set of managers with another, or indirectly, through the decline of poorly managed firms and the growth of well-managed firms.

But some of this variation in rates of return over any particular period can also reasonably be attributed to genuine uncertainty about the future performance of different possible investments. Even in a competitive system of investment firms that are providing retirement annuities, some of them will earn higher returns over any particular period than others will, and for reasons having nothing to do with the effort and the quality of management but having to do only with circumstances that truly could not be foreseen.

It cannot be claimed that each private supplier of retirement annuities will yield as high a return as possible, in light of the preferences of investors for risk and the like, but the market process will tend to replace less efficient with more efficient management. The operation of a funded system of Social Security by government raises new questions of incentive that have been explored in the recent literature on bureaucracy.[14] In comparing the conduct of profit-seeking firms and governmental or other nonprofit agencies, the presence or absence of residual claimancy creates an additional and systematic source of variation in conduct. In a profit-seeking firm, there is some person or are some persons—such as stockholders of corporations—who bear a status of residual claimancy, which means that these people bear the consequences, for good or for ill, of "unforeseen" events. There are two categories of "unforeseen" events. One deals with events that arise because the observer was either relatively incompetent or relatively inactive. The other refers to events that arise even though the observer was both competent and active.

A status of residual claimancy creates a strong incentive to avoid the "unforeseen" events that would arise through incompetence or inactivity. Nothing can be done, of course, about events that would arise through genuine uncertainty. This incentive to avoid unforeseen events is weaker under a nonprofit or collective form of

[14]For a brief survey of this literature, see Richard E. Wagner, *Public Finance* (Boston: Little, Brown & Co., 1983), pp. 108–28.

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organization, because any gain or loss is not concentrated on particular residual claimers but rather is diffused throughout the relevant population.

This property of differing ownership arrangements has by now been studied for various cases. Some interesting and pertinent data for the case at hand may perhaps be gleaned by comparing the investment performance of foundations to that of mutual funds. Foundations are more akin to government under a funded system, while mutual funds are more akin to individual firms in an industry of private providers of retirement annuities. Using data for 1968, the Commission on Foundations and Private Philanthropy found that foundations received an average return on their portfolios of 5.6 percent, whereas mutual funds received an average return of 15.3 percent.[15] Similarly, the rate of turnover of foundation portfolios ran in the vicinity of 1 to 2 percent, whereas it was about 10 times higher for mutual funds.[16]

The return that people might get under a funded system of Social Security clearly seems to depend on the incentives that managers of the fund possess. A system in which managers are paid only by salary would differ significantly from one in which they are paid to some extent through some type of profit-sharing payment. Besides depending on incentives, the return that a funded system will offer will depend on the constraints imposed on fund managers regarding such things as their ability to reward and penalize subordinates. It is by no means clear that a funded system, even if it can be kept intact, will give people as good a return as they could expect to get through a system of competing private suppliers. Indeed, under prevailing institutional arrangements and the incentives these entail, it seems exceedingly unlikely that a funded system operated by government will perform as well for people as a system of competing suppliers.

Funding and Government Regulation of Credit Markets

Under a funded system of Social Security, the federal government would become the dominant supplier of saving in credit markets. Under present conditions, the federal government would supply in the vicinity of 50 percent of all saving. There would probably be few if any areas where some money could not be attributed to government's Social Security fund. Government money is, of course, a

[15]Commission on Foundations and Private Philanthropy, *Foundations, Private Giving, and Public Policy* (Chicago: University of Chicago Press, 1970), pp. 74–75.

[16]Moreover, in this particular case the difference was substantial. With foundation assets at the time in the $20-to-30-billion range, the lost income of $2 to 3 billion annually was roughly equal to the actual amount of foundation giving.

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prominent instrument by which the federal government gains some control over activities that are not under its constitutional authority. For example, we have a long record of how conditional grants-in-aid have been used by the federal government and by the various participating interest groups to circumvent the constitutional allocation of responsibilities between the federal government and the states. Thus we have the federal government setting speed limits on highways and regulating advertising alongside highways, even though constitutionally highways are clearly the province of the states.

The presence of federal money does not always lead to regulation, it might be noted. The case of Hillsdale College might be thought of as setting some limits here.[17] This case might be thought to show that if the link or route between the federal government and some activity the government wants to regulate is too remote or circuitous, the government will be unable to use money as justification for regulation. Although Hillsdale College took no money directly from the federal government, some of its students received such money. The federal government used this relation between it and those students in an effort to force Hillsdale to comply with various federal regulations. Hillsdale was upheld in this case; hence it might be thought that there are at least some limits on the power of the federal government to use some presence of federal money as a means of extending its regulatory reach. However, it should also be noted that Hillsdale incurred considerable costs in defending itself, and in a case that was clearly absurd. In how many equally absurd cases would defendants acquiesce because of the high cost of defense?[18] If anything, the Hillsdale case is surely the proverbial exception that proves the rule: The presence of federal money serves as an entering wedge for the federal regulation of areas not constitutionally subject to such control.

Whether such a wedge is actually used in particular cases, and how it will be used, will depend on the costs and gains perceived by the various participants involved. For example, Davis-Bacon type provisions could be extended throughout the construction industry as federally supplied saving became diffused throughout the construction and mortgage markets. It is not unimaginable that multifarious requirements regarding the design of buildings, the

[17]*Hillsdale College* v. *Department of Health, Education and Welfare et al.*, 696 F.2d 418 (6th Cir. 1982).

[18]For a general treatment of the possibly negative relationship between personal liberty and government spending, see Roland N. McKean, *Public Spending* (New York: McGraw-Hill, 1968), pp. 107–24.

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purposes that they must or can serve, and numerous other demands would be similarly imposed. What particular impositions might emerge would depend upon the particular identity of the highest bidders for legislation in a given situation.[19] It might be required that houses be built at least partially underground. It might be required that apartment complexes be required to house a mix of residents by such characteristics as income, race, and family size. The possibilities would be limited only by one's imagination and by the strength of the costs and gains to various people of seeking favorable legislation and of opposing unfavorable legislation.[20]

The Ultimate Impossibility of Collective Funding

Any effort to operate a funded system of Social Security through government would have to develop various rules to ensure that the fund would perform as well as a competitive system of private providers of annuities. And despite the most strenuous efforts to this end, this effort seems unlikely to succeed. Indeed, there is an important body of economic literature that suggests that it would be impossible for a funded system to be operated as efficiently as a competitive system of private suppliers, because both the knowledge and the incentive required for such a task would be absent. This is the central conclusion of the economic theory of socialism, which is sometimes known as the theory of economic calculation.

That theory, which originated in the 1920s, stemmed from socialist proposals to replace markets with planning as the means of resource allocation, for only in this manner could commodity production be abolished and alienation overcome. Ludwig von Mises succeeded in showing that in such a socialist system it would be impossible for the structure of production to adapt efficiently to consumer wants, because the knowledge necessary for economic calculation could not be generated.[21] The subsequent socialist literature did not argue that the prevailing pattern of consumer wants was irrelevant because it reflected the capitalist process of commodity production. Instead, this literature retreated from the abolition of markets and proposed instead some variant of what was called market socialism, which (as

[19]On legislation as an ordinary economic activity, see Robert E. McCormick and Robert D. Tollison, *Politicians, Legislation, and the Economy* (Boston: Martinus Nijhoff, 1981).

[20]Indeed, the leverage that a funded system of Social Security might offer for an extension of federal regulation may well be seen by some people as an argument in favor of funding, even if they were not concerned or convinced about the negative impact of a pay-as-you-go system on saving and capital formation.

[21]See the essays collected in Friedrich A. Hayek, ed., *Collectivist Economic Planning* (London: Routledge and Kegan Paul, 1935).

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Paul Craig Roberts noted) was hardly socialism at all, because commodity production was maintained; instead, this system represented "a polycentric system with signals that are irrational from the standpoint of economic efficiency."[22]

As a result, the existence of a market process became widely recognized as an essential condition for economic calculation. What was not so widely accepted was whether economic calculation could take place in a quasi-market order in which there existed collective ownership of capital goods. Within a static-equilibrium framework, there seemed to be no essential difference between the abilities of capitalist and socialist economies to solve the problem of economic calculation, considering that socialism now referred to commodity production for markets instead of production for use in the absence of markets, as it had meant before von Mises' critique. It is not surprising that the adoption of different perspectives toward the nature of the economic process resulted in different formulations of what was required for economic calculation.[23] A model of static equilibrium made the task of economic calculation under socialism appear simple and straightforward, as embodied in suggestions that socialist managers be instructed to set price equal to marginal cost. Within a model of static equilibrium, it is presumed that knowledge can be described fully, like the cards dealt in a poker game, and the problem of economic calculation is simply one of getting consumers and producers to say truthfully just what cards are in their hands.

But once it is recognized that knowledge has, among other things, a substantial tacit component, the abilities of external observers to judge whether someone is properly using knowledge disappears, and emphasis can no longer be placed on methods that are predicated on explicit knowledge.[24] Instead, what must take place is a shift of

[22]Paul Craig Roberts, *Alienation and the Soviet Economy* (Albuquerque: University of New Mexico Press, 1971), p. 84. See also idem, "The Polycentric Soviet Economy," *Journal of Law and Economics* 12 (April 1969): 163–79; and idem, "Oskar Lange's Theory of Socialist Planning," *Journal of Political Economy* 79 (June 1971): 562–77.

[23]For a careful examination and discussion of this point, see Karen I. Vaughn, "Economic Calculation under Socialism: The Austrian Contribution," *Economic Inquiry* 18 (October 1980): 535–54. For a symposium on the theory of economic calculation, see the entire issue of the *Journal of Libertarian Studies* 5 (Winter 1981), particularly the first three essays: David Ramsey Steele, "Posing the Problem: The Impossibility of Economic Calculation," 7–22; Robert Bradley Jr., "Market Socialism: A Subjectivist Evaluation," 23–29; and Don Lavoie, "A Critique of the Standard Account of the Socialist Calculation Debate," 41–87.

[24]Michael Polanyi has aptly summarized the distinction between tacit and explict knowledge: "Things of which we are focally aware can be explicitly identified; but no knowledge can be made *wholly explicit*. . . . Hence, tacit knowing is more fundamental

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focus to the properties of different processes for making use of such nonarticulatable but real phenomena as tacit knowledge. In this regard, the theory of economic calculation explains that any such process must contain the central institutional elements of property, contract, and residual claimancy. Prices, which arise through contract, are an important source of the knowledge necessary for effective economic conduct. They are also an important source of incentive, for in conjunction with residual claimancy they provide a means of rewarding effective action and penalizing ineffective action.

A funded system of Social Security runs counter to the basic requisites of economic calculation, unless such a system were simply one option among many, with the governmental option being given no advantage by government over the other options. It is impossible to determine what would constitute an efficient program or set of programs independent of a competitive market process operating within a framework of property, contract, and liability. Consequently, there is no set of administrative rules or legislative constraints that could be articulated that would be capable of assuring efficient outcomes. This is analogous to the point that it is impossible for any external observer to discern whether a particular public enterprise is adhering to a rule of setting price equal to marginal cost. Cost is the anticipated value of the option that is necessarily given up to secure the option in question. While people may come to form the same anticipation in a truly static economy, no such identity of anticipations is possible in the presence of continuous change. When people differ in their assessment of future possibilities, the marginal cost of any particular action will depend on individual judgments regarding the future.[25] Therefore, an instruction to set price equal to marginal cost will give no clear guidance, which means, among other things, that there is no objective means of checking the compliance of managers with some rule of setting price equal to marginal cost.[26]

People can reasonably differ in their anticipations regarding such pertinent future circumstances as patterns of mortality, effects of

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than explicit knowing: *we can know more than we can tell and we can tell nothing without relying on our awareness of things we may not be able to tell.*" See Michael Polanyi, *Personal Knowledge* (London: Routledge and Kegan Paul, 1958); Polanyi's emphasis at p. x of Torchbook edition, 1964.

[25]On the subjectivity of cost, including a consideration of the implications of such subjectivity for economic calculation, see James M. Buchanan, *Cost and Choice* (Chicago: Markham, 1969).

[26]See, for instance, the thorough discussion in Jack Wiseman, "Uncertainty, Costs, and Collectivist Economic Planning," *Economica* 20 (May 1953):118–28; reprinted in James M. Buchanan and G. F. Thirlby, eds., *L. S. E. Essays on Cost* (London: Weidenfeld and Nicolson, 1973).

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medical science upon physical vigor, destructiveness wrought by a future war, as well as differing in anticipations about possible social innovations and practices. (For example, the development of insurance was one such innovation in the past, and the replacement of extended families in rural settings by nuclear families in urban settings was one such relevant practice or condition.) Consequently, there is no uniquely correct view of the future, even if all people are of the same mind. And this lack of uniqueness is strengthened once it is admitted that people may differ in their own evaluations of those different possible states. Hence, an efficient approach to retirement insurance cannot be assessed except as it emerges through a consensual process based on the institutions of property and contract—this is the central theme of the theory of economic calculation.

If the insurance and welfare components of Social Security are separated, the efficient provision of those annuities can only take place within some type of truly consensual or contractual institutional order. A requirement that people belong to the governmentally funded system renders efficient provision impossible, for such an approach to provision runs afoul of the essential requirements for economic calculation, because knowledge would be destroyed and incentive weakened. There is no particular reason for being opposed to governmental operation of a particular program or plan for retirement annuities, as long as the government fund competes on equal terms with other funds. But if the government fund were to acquire a favored, monopolistic status, either by requiring participation or by imposing strong enough regulations on private funds to render those offerings generally inferior to those of the government's fund, the requisites for economic calculation would have been erased. Thus, the general assurance that people are getting the best deal they can on their savings would have vanished.

Actuarial Fairness and Competitive Provision

It is often claimed that the market provision of retirement annuities could not take place in an actuarially fair manner. Kip Viscusi and Richard Zeckhauser, for example, argue that "because of large transactions costs and problems of adverse selection, private annuities are not available on an actuarially fair basis."[27] But what is an actuarially fair basis? An actuarially fair amount to pay for a gamble that pays $6 upon guessing the correct number of a single throw of a die is $1—

[27]W. Kip Viscusi and Richard Zeckhauser, "The Role of Social Security in Income Maintenance," in *The Crisis in Social Security* (San Francisco: Institute for Contemporary Studies, 1977), p. 52.

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as a first approximation. As a closer approximation, the actuarially fair amount to pay would be somewhat higher than $1, because the price of the bet must also cover the cost of organizing the game.

But what is actuarial fairness in the provision of retirement annuities? Suppose that people have on average a life expectancy of fifteen years when they are age 65. Assuming, for computational ease and without distorting the central point, that the rate of interest is zero, people who have accumulated $300,000 by age 65 should be able to buy annuities that pay them $20,000 per year. This is an actuarially fair annuity—as a first approximation. But what about a closer approximation? For instance, is it necessarily actuarially unfair if someone is offered only a $15,000 annuity? Not necessarily, for there are a number of reasons why this might happen without violating the presumption of actuarial fairness. One obvious factor is the cost of operating the insurance enterprise, which reduces the annual payments that can be financed from a given capital sum, as compared with what would be possible under a regime of zero transaction costs. But in the real world, these costs of operation are a necessary part of the process of promoting actual actuarial fairness.

Another possible factor concerns anticipations of possible future longevity. What is relevant is the average age at which people who are presently 65 will actually die, and not a recent history of the average age of death of those who had actually lived to age 65. Anticipations pertaining to such things as international affairs and public policies are also relevant in governing the terms of trade between a capital sum and an annuity promise. Once anticipations about the future enter, there is no unique notion as to what constitutes actuarial fairness. There is no way any outside observer can say whether or not a particular offer of an annuity is actuarially fair, because the quality of fairness depends, among other things, on people's present anticipations about what things will be like in the future, as well as on their preferences for or against bearing the uncertainty that is inherent in any market for annuities. All that can be said is that a competitive process of providing annuities will tend to create a set of offerings that represents the best deal that people are willing to agree to.

Adverse selection does not upset the case for competitive provision. People who recognize that they have traits strongly associated with longevity will have a stronger-than-average interest to participate, if they can participate on the same terms as others. Competition will tend to bring about a zero-profit equilibrium in any event. Suppose there are traits other than age that affect longevity—traits known only to the particular individuals and not to potential insurers; and

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further suppose that it would be impossible for insurers to discern those traits. As compared with a standard of omniscience, the market provision of annuities would favor those who had traits conducive to longevity. Those with long life expectancies will get annuities on more favorable terms than if insurers knew the "truth" about them. In like manner, those with shorter life expectancies will get annuities on less favorable terms. This differential in treatment, however, is inherent in the absence of omniscience, and could not be corrected by a governmentally operated system of funding.

Alternatively, suppose it is possible for insurers to gain knowledge about some of the traits besides age that influence longevity. The process of competition in a competitive market for annuities will tend to induce the collection and utilization of the added information as long as the gain from the more accurate classification of people exceeds the cost of that information. As a result, the differential in treatment of people with significantly different life expectancies will diminish. Such a differential will never vanish, of course, because omniscience would be necessary for that to happen, as a unique annuity would be applied to each person. And there is nothing in collective provision that would be able to promote a more effective production and utilization of information. Indeed, actuarial unfairness seems more likely to be encountered in a governmentally operated system of funded Social Security than in a system of private suppliers. In the absence of omniscience, people must be placed into categories. As noted above, such categorization will proceed as long as the gains in the form of added business exceed the cost of refining those categories. One particular implication of the zero-profit character of competitive equilibrium is that the supply of annuities from a competitive industry will tend to produce as much actuarial fairness as is efficient in light of the cost of knowledge.[28] By contrast, in a governmentally operated funded system, less knowledge would be generated about future possibilities, and moreover, in the absence of competition there would be a stronger likelihood of politically based discrimination among people. If actuarial fairness is desired,

[28]On this distinction between reasoning on the basis of a presumption of omniscience and reasoning on the basis of a presumption of ignorance combined with social processes for utilizing limited knowledge through a network of markets, see the extraordinarily cogent treatment by Thomas Sowell in *Knowledge and Decisions* (New York: Basic Books, 1980). This line of inquiry descends directly from several of the essays reprinted in Friedrich A. Hayek, *Individualism and Economic Order* (Chicago: University of Chicago Press, 1948), particularly the essay "The Use of Knowledge in Society."

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competitive provision and not government provision is the only possibility: This is a corollary of the theory of economic calculation.

What Regulation for a Private System?

In thinking about a system of competitive producers of retirement annuities, the question of regulation must be faced. Such programs as Individual Retirement Accounts and Keogh plans entail legislation that gives them tax-exempt status and regulation that restricts such things as the types of permissible investments and the ability of people to alienate their ownership. Like regulation generally, some types of regulation of the suppliers of retirement annuities might provide general gains to all, while other types of regulation might be generally harmful but provide benefits to particular sets of people at the expense of everyone else. A proliferation of the latter type of regulation can, of course, undo much of the advantage of a competitive system, by lowering the rates of return that people can receive. Regulation can also be used to force transfers of income among the participants of an ongoing system, as with the recent efforts to abolish sex as information on which annuity contracts may be based. It is certainly possible that a regulated system of private insurance will look quite different from a genuinely competitive system, and furthermore will not operate very differently from a governmentally operated system. In any event, any eventual consideration of the competitive provision of retirement annuities must confront the question of regulation.

Forced Saving

The only aspect of such possible regulation I wish to consider here is the near-universal acceptance of the proposition that people should be required to contribute a minimum percentage of their income to some such fund. The life cycle of people is almost universally one in which they are substantial net borrowers during their early years of work, as they have relatively low earnings along with relatively high expenses associated with such things as buying houses and raising children. It is only during their middle years of life that people typically become net savers, when their incomes are in their peak range, their children are on their own, and so on. In the absence of a requirement that they contribute to a retirement fund throughout their working lives, people typically would not start saving for their retirement until they reached this middle stage of life.

A requirement that people must save at the same rate throughout their working lives obviously interferes with the life-cycle plans of

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most people. Furthermore, this interference entails both a social waste and a transfer of income to particular beneficiaries of such a regulation. A requirement that people save throughout their working lives leads people to increase their borrowing during their early years— and by an amount that roughly offsets the required savings. Since the price at which people can borrow exceeds the return they can get on their forced saving, these people will be worse off. Some of their loss may represent an offsetting gain to the owners of financial institutions. This will happen to the extent that financial regulation promotes industry monopoly. In this case, some of the difference between rates paid by borrowers and rates paid to savers represents monopoly profit within the industry. Additionally, part of the spread between borrowing and lending prices reflects the cost of resources involved in the administration of such credit transactions. For the transactions that would have been unnecessary because internal finance would have been used in the absence of forced saving, the result is a social waste, as people use up resources in undoing the effect of that regulation.

Requiring people to save for their retirement when they are in a stage of life in which they are raising families and in which their incomes are increasing relatively rapidly toward their peak range, then, does two things: (1) It taxes such people for the benefit of the owners of financial institutions; and (2) it involves a waste of resources, because resources become employed in undoing what the regulation sought to accomplish, but could not—namely, a rearrangement of intertemporal patterns of saving and borrowing. In recognition of this property of this type of regulation, one might wonder whether an alternative rule might not be preferable, say one in which mandatory saving takes place only after, say, age 40. But even this approach cannot accommodate the substantial differences that exist in the circumstances of different people. Some may have children early in life, others later. Some may have none. While life-cycle patterns of income generally show an inverted U-shape in relation to age, there is much variation in the timing of peak ranges among both individuals and occupations. No rule can accommodate such circumstances as fully as people can accommodate them by acting on their own behalf through a regime grounded in property, contract, and liability: This also is a corollary of the theory of economic calculation.

Shortsightedness

So why have any regulatory rules at all, at least with respect to a required pattern of saving? Why not allow people to choose to provide for their own futures as they think best? It is often asserted that

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substantial numbers of people will fail to provide for their retirement, in the absence of compulsion to overcome such shortsightedness. If such shortsightedness is thought to be general throughout the population, the entire case for democratic government would, of course, seem to vanish. If people are generally incapable of projecting the future with regard to providing for their retirement, they are surely at least as incapable of making choices among competing candidates for political office, because many of the facets of such a choice require a similar projection of the future.

But if it is thought that such defective foresight plagues only some people, one might wonder why the prudential remainder of the citizenry should bear the burden of being unable to develop and choose preferred courses of personal provision because of the shortsightedness of a few. One might equally well wonder whether such a regulation is really a means not of counteracting defective foresight but of transferring income to financial institutions.[29] For instance, evidence presented by Carolyn Weaver suggests that in the period before Social Security, the problem of dependency among the aged was small.[30] In New York State in 1929, nearly 95 percent of people over age 65 were self-supporting. Moreover, in a number of surveys of the elderly in different cities over the 1925–29 period, fewer than 10 percent were regarded by government commissions as in need of assistance. Moreover, most of the source of low standards of living among the elderly was attributed not to shortsightedness but to low incomes throughout their working lives.

Indeed, basic economic analysis suggests that what might appear to be shortsightedness is really just a rational response to existing opportunities that reward people for failing to provide for their futures. It is costly to provide for one's future, and the less costly a failure to do so becomes, the less people will make such provision. In other words, Social Security would promote a rational response that might be characterized as shortsightedness. This interpretation seems far more consistent with both history and reason, and moreover is just another manifestation of the proposition that people reduce their saving in response to Social Security.

Thomas Szasz' work *The Myth of Mental Illness* seems to have much pertinence here, particularly his chapter on "The Ethics of

[29]This is the approach increasingly taken by the economic theory of regulation: "The announced goals of a policy are sometimes unrelated or perversely related to its actual effects, and the *truly intended effects should be deduced from the actual efforts.*" George J. Stigler, *The Citizen and the State* (Chicago: University of Chicago Press, 1975), p. 140 (author's emphasis).

[30]Weaver, pp. 41–44.

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Helplessness and Helpfulness," where he notes: "Not only do some Biblical rules foster dependency; they also lay the groundwork for using lack of foresight and incompetence as weapons to coerce others to provide for one's needs."[31] It is not that people are inherently shortsighted but that they will act in that manner if it pays to do so. Moreover, there is a payoff to those directly involved in covering up the consequences of such shortsightedness, as long as the means to do this are extracted from others through taxation, as against being supplied directly by those so involved. It seems, in other words, to be the paternalistic state that corrodes self-reliance and the supporting institutions that would otherwise develop in response, and not self-reliance that somehow weakens, with the paternalistic state then arising in response. Therefore, it is inappropriate to infer on the basis of today's paternalistic institutions the degree to which people would fail to provide for their future in the absence of those institutions. Of course, there are presently substantial failures to so provide, but such failures are only a rational response to the growth of paternalistic institutions outside the family.

Social Security and the Servile State

There is no question about the substantial interest that people have in bringing some measure of security to their future. But different ways of doing this have important consequences for saving and capital formation, and hence, for future well-being. A pay-as-you-go system of Social Security reduces saving and capital formation, and thus actually acts to erode the very means by which whatever security there is can be provided. A governmentally operated funded system would fare better on this account, but there are some matters of knowledge and incentive that make the market organization of competing suppliers a superior alternative.

Different approaches to the provision of security may also have consequences that extend beyond matters of saving and capital formation. Unlike market approaches, where people acquire ownership titles to assets, people do not acquire title to assets under collective provision—especially not under the pay-as-you-go approach, but also not under a funded approach. Collective provision is proletarian in

[31]Thomas S. Szasz, *The Myth of Mental Illness* (New York: Harper and Row, 1964), p. 197. One particularly clear statement that expresses Szasz' central theme appears on p. 225: " 'Mental illnesses' thus differ fundamentally from ordinary diseases and are similar, rather, to certain moves or techniques in playing games. Suffering from hysteria is thus far from being sick and could more accurately be though of as playing a game, correctly or incorrectly, skillfully or clumsily, successfully or unsuccessfully, as the case might be."

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its orientation, with security being dispensed through the taxing-and-transferring apparatus of the state and its bureaucracy. Wealth becomes in important measure a common pool to be fought over by using the instrumentalities of government, causing social life increasingly to take on the character of a clash among warring factions. Such an approach to security might be called status-extending and is an aspect of what Hilaire Belloc called the *servile state:* "That arrangement of society in which so considerable a number of the families and individuals are constrained by positive law to labor for the advantage of other families and individuals as to stamp the whole community with the mark of such labor. . . ."[32]

In contrast, what Belloc, along with G. K. Chesterton, called the distributive state, in which the ownership of property is widespread and is held severally and not collectively, seems to illustrate contract-extending approaches to security. Arrangements for market provision provide security by extending the domain over which contract operates. Such an approach is grounded in personal responsibility and the ownership of assets. Suppose characteristics such as self-reliance and personal responsibility may be nurtured or starved, depending on (among other things) whether the approach to Social Security is contract- or status-extending. To the extent that these bourgeois characteristics are essential for a liberal society, prevailing governmental systems of Social Security, by promoting proletarian characteristics, may facilitate the antiliberal movement of contemporary policy. The ownership of property and the responsibility for it may be important in supporting social relations ground in reciprocity and contract, just as the absence of such ownership and responsibility may reinforce social relations grounded in status and ordering. If so, the choice between pay-as-you-go and genuine funding may involve more than a choice about how wealthy we will be when we retire. By influencing knowledge and incentives and their political expression, such a choice might exert some influence over whether society will be more liberal or less liberal in the future. Such matters are, of course, a topic for a quite different paper than this one, but all the same such matters may be part of what is ultimately involved in a choice among alternative arrangements for providing security in a society.

[32]Hilaire Belloc, *The Servile State* (original ed., 1913; Indianapolis: Liberty Press, 1977), p. 50.

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BEYOND EFFICIENCY: A COMMENT

Roger Pilon

The role of the critic is always enjoyable when it affords an opportunity to set the record straight. I am afraid, however, that no such opportunity is afforded here, for Professor Wagner has himself set the record very straight indeed. He has written an excellent paper, exploding any number of all-but-sacred myths that have surrounded the American Social Security experiment from the start. His discussion, for example, of the ultimate impossibility of efficient public funding, due to the absence of the requisite knowledge and incentive, is especially illuminating. And his arguments against even private funding, when it is made compulsory, are nothing if not refreshing.

Accordingly, because I find so little in this paper to criticize, I shall understand my assignment as affording an opportunity rather more to build upon Professor Wagner's arguments than to criticize them. In particular, I want to try to draw out a few of the normative features of the critique of Social Security that Professor Wagner has only touched upon, which will enable me to sharpen somewhat the distinction between these normative features and the efficiency or economic features of the critique that constitute the core of his argument.

Before I begin, however, I need to dissociate the administration I serve from anything I say here. I feel a little like David Hume in this, when he argued, before a group of his philosophical colleagues, that causality is a contingent, not a necessary feature of the world, and that just because a man falling out of a window fell downward on every previous occasion, it did not follow, with logical necessity, that he would fall downward on the next occasion. At that, one of Hume's colleagues is said to have pointed to the window, inviting the philosopher to leap, whereupon Hume replied: "But I distinguish my philosophical from my practical life." In that spirit, the

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The author is special assistant to the general counsel, U.S. Office of Personnel Management, Washington, D.C. 20415.

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views I express here are my own, not necessarily those of the Reagan administration or the Office of Personnel Management. Any congruence between the two should be seen, therefore, as coincidental—albeit a happy coincidence, I should add.

Turning then to Professor Wagner's discussion, he begins by distinguishing between the insurance and the welfare elements in the Social Security program, after which he explores, at considerable length, some of the central properties of collective and private alternatives for the provision of the retirement insurance component. Although he does not say so in so many words, he concludes with the disarmingly radical proposal—radical in contrast to the conventional wisdom—that we eliminate the compulsory insurance element of Social Security—whether private or public—and permit instead whatever voluntary, private arrangements might arise; for nothing but a voluntary, private arrangement would be efficient or, as he notes in his final remarks, would yield personal characteristics conducive to a liberal society. Once again, I entirely agree with Professor Wagner's conclusions and with his cogent arguments in support of them. What I want to add is simply this, that not only would a voluntary, private arrangement be more *efficient* than any alternative arrangement, but nothing but a voluntary, private arrangement would be *just*, would respect the rights of individuals to freely provide for their own security, to provide for the security of others—or, indeed, to refrain from so doing, if that is what they chose.

On two fundamentally different grounds, then, from considerations of economic efficiency as well as from a consideration of moral rights, the Social Security program is flawed. First, as Professor Wagner and many others have made clear, the system is a monumentally inefficient and, indeed, a failing program for addressing the problem of financial security in retirement. Second, even if it were the very model of economic efficiency, by virtue of its elements of forced association and transfer, the system violates fundamental rights of property, association, and contract and so is unjust.

These conclusions from ethics are rather easier to state, of course, than they are to defend. Certainly in the scope of this comment I will be able to do little more than make a few points related to their defense. In order to do even that, however, it would be well first to return to Professor Wagner's paper by way of further sharpening the distinction I have just drawn. In particular, I want to try to elucidate the following point: That while there are moral or evaluative implications of the efficiency considerations Professor Wagner focuses upon—moral implications that properly operate in the political decision-making context—these value issues should be clearly dis-

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tinguished from the rights issues I have just mentioned. Rights and values are *not* the same kinds of moral notions: Most particularly, rights are not simply values or interests that rise to a certain level of importance, at which point they become rights. Indeed, we hold rights quite apart from whether we may or may not value the objects of those rights.[1]

Returning then to Professor Wagner's thesis, when he talks about incentives for capital dissipation, or the likely effects should government become the dominant supplier of funds in the credit markets, or the tendency of the paternal state to corrode self-reliance, we should notice precisely what it is he is doing. Strictly speaking, he is not really trying to *justify* his conclusions. Rather, he is engaged in an *explanatory* undertaking: Given certain incentives, that is, or certain changes in incentives, he is explaining and predicting what behavior or behavioral changes and what income and distributive effects we are likely to see. Not that he is necessarily evaluatively neutral about that behavior or those effects: Indeed, if put to the test, I rather think I know where he would come out in any particular case, in any particular value choice. But strictly speaking, as a positive economist, he can stay above the moral fray; he need not succumb, that is, to the Posnerian temptation to get right down there in the wealth-maximization mud, but instead can remain above it all, in a kind of austere, Stiglerian splendor, telling the legislators "Here is what you will get if you do what you propose to do; I am not here to say whether what you will get is good or bad; I am just telling you what effects your proposed legislation is likely to produce."[2]

In order to move from the explanatory to the justificatory mode, then, Professor Wagner would have to start evaluating the ends and means before him on some evaluative criterion. Again, as a careful economist, what little of this he does is done rather more by implication than in any explicit way. He observes, for example, that pay-as-you-go systems actually *reduce* security. Or he speaks of the socially wasteful effects of even compulsory *private* annuities and of the transfers such annuities would entail, leaving it to us to infer that he is not in favor of reduced security or social waste or transfers. Such inferences, however, are no part of his explanatory work as a positive economist. Indeed, there are economists who support certain measures

[1]See H. L. A. Hart, "Are There Any Natural Rights?" *Philosophical Review* 64 (April 1955): 186.

[2]See Richard Posner, "Utilitarianism, Economics, and Legal Theory," *Journal of Legal Studies* 8 (January 1979):103–40. I have criticized these views in my article "On Moral and Legal Justification," *Southwestern University Law Review* 11, no. 4 (1979): 1334–38.

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precisely *because* they entail their favored sorts of transfers, notwithstanding the implications of such measures for social wealth.

Where those justificatory arguments *do* come to the fore, of course, is in the political decision-making context. Legislators in particular will make explicit their taste or distaste for such consequences as Professor Wagner has pointed to. More precisely, when legislators attempt to justify particular enactments, they will do so in one or both of two ways: They will point to the ends or consequences the legislation seeks to bring about; or they will point to the process by which the legislation was enacted. Thus, they might point to the need for universal financial security for the retired by way of justifying compulsory private annuities, valuing this end more highly than they disvalue the attendant transfers and social waste. Or they might point to the democratic process by which such a tradeoff was determined. In the first case they would justify their policy or program by reference to the *consequences* or *net good* the policy or program was expected to yield. This would be a consequentialist justification, based upon the values they placed upon the various consequences of the policy or program. In the second case, they would justify their policy or program by reference to the *process* by which it came about—presuming, by implication, the Nozickian insight that just processes yield just results.[3] This, then, would be a rights-based justification.

Now against these kinds of justificatory claims, rejoinders from considerations of economic efficiency will not avail. For the issue is not, as with the straightforward Social Security case, that the stated ends of the legislature will not be achieved by the legislative means chosen, which the economist can easily demonstrate. Rather, the stated end, universal financial security for the retired, *will* be achieved by compulsory private annuities, albeit not by the most efficient or just means. In order to achieve their objective, that is, the legislators have simply elected a less efficient and just policy than they otherwise might have done.

If we are to show, then, that compulsory private annuities are unjustified—or indeed that *any* enactment that entails forced transfers and hence takings of liberty and property are unjustified—it will not do to proceed from considerations of consequences, including economic efficiency as but one among many such consequences. For the legislature, in the case at hand, has already done its consequentialist calculation and has decided against efficiency as the dominant

[3]See Robert Nozick, *Anarchy, State, and Utopia* (New York: Basic Books, 1974), pp. 149–60.

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consideration. What we need to do instead, then, is leave the consequentialist mode of justification altogether—which has been fraught with insurmountable difficulties since Bentham first set about the development of a utilitarian calculus—and turn instead to the rights-based, process mode of justification as sketched by Locke, as understood intuitively by Jefferson, and as developed more fully by Kant and, more recently, by Nozick and other contemporary philosophers.[4]

Continuing, for example, with the case before us—namely, a statute compelling private annuities—an indirect rights-based rejoinder might begin by going straight to the political jugular, to the political decision-making process itself, including the democratic decision-making process. Now before I inveigh against so hallowed an institution as democracy, let me try to avail myself of what protection I can find in the observation that I follow a long tradition here, stemming at least from Plato and Aristotle, although the arguments I will barely be able to mention are of substantially more recent vintage. There are first the arguments from decision theory that show that rarely if ever do we get majoritarian preferences from majoritarian processes.[5] So compelling are these arguments that they simply cut the factual floor out from under the democratic assumptions. But even if the majoritarian process did yield majoritarian preferences, absent some primordial unanimous consent, which has ever been a myth, much less a consent that binds heirs, that process can hardly address the fundamental question of political theory: By what right does one man have authority over another?[6] So compelling are the moral arguments from theoretical anarchism, that is, that not even the recent and brilliant work of Nozick has succeeded in overcoming them.[7] Not that I am calling for anarchism, mind you. With Hume, again, I distinguish my philosophical from my practical life—and, I might add, from my political life. But I do mean to point to the fundamental air of illegitimacy that has ever surrounded the collectivist engine, whether driven by a majoritarian or by any other preference save unanimity. And I would hope that an appreciation of that

[4]See, e.g., Alan Gewirth, *Reason and Morality* (Chicago: University of Chicago Press, 1978); Alan Donagan, *The Theory of Morality* (Chicago: University of Chicago Press, 1977); Charles Fried, *Right and Wrong* (Cambridge, Mass.: Harvard University Press, 1978).

[5]See William H. Riker, "Implications from the Disequilibrium of Majority Rule for the Study of Institutions," *American Political Science Review* 74 (1980): 432–46.

[6]See Robert Paul Wolff, *In Defense of Anarchism* (New York: Harper & Row, 1970).

[7]See Nozick, part I. I have criticized these arguments in "A Theory of Rights: Toward Limited Government" (Ph.D. diss., University of Chicago, 1979), chap. 4.

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air of illegitimacy might serve as a brake upon state action—and in particular upon trying to do "good" through state action.

But what, after all, is the Social Security program if not just that—an attempt to do good through state action? Like most other legislative measures—certainly most 20th-century measures—it joins individuals, many of them unwilling participants, in the collective pursuit of some "social good." In so doing, it violates the fundamental rights of property, liberty, and association of the unwilling participants. The direct rights-based rejoinder, then, proceeds not simply from a dispositive critique of the democratic process but from the affirmative theory of individual rights. It is a long and detailed undertaking of many parts, aimed ultimately at supplying the justificatory foundations for the conclusions set forth in the Declaration of Independence and the Bill of Rights, and aimed as well at dispatching Franklin Delano Roosevelt's "second Bill of Rights"—his "security rights," so called.[8] For if the classical rights of individual liberty and private property are justified, they allow no room for these "security rights," except insofar as such rights are created through voluntary processes, which alone are consistent with rights of liberty and property. Once again, however, none of this affirmative theory can be developed here.[9]

In summary, then, Professor Wagner's paper has set forth a number of important arguments aimed at demonstrating the untenability not simply of the Social Security program but of any compulsory retirement security program. In the end, however, his arguments depend upon a certain ordering of preferences, a certain value structure, which many of us may share, but which many legislators may not. Accordingly, his arguments need to be buttressed by further arguments, taken not from the theory of value, whether economic or moral, but from the classical theory of rights. And those arguments need to be directed not to the legislature but to the courts.

[8]See Franklin Delano Roosevelt's message to Congress, January 11, 1944, and his Chicago speech, October 28, 1944, cited by Edward S. Corwin, *Liberty Against Government* (Baton Rouge, La.: Louisiana State University Press, 1948), pp. 4–5.

[9]For a fuller discussion of this theory, see my articles mentioned above as well as the following: "Ordering Rights Consistently: Or What We Do and Do Not Have Rights To," *Georgia Law Review* 13 (Summer 1979): 1171–96; "Corporations and Rights: On Treating Corporate People Justly," *Georgia Law Review* 13 (Summer 1979): 1245–1370; "On the Foundations of Justice," *Intercollegiate Review* 17 (Fall/Winter 1981): 3–14; "Capitalism and Rights: An Essay Toward Fine Tuning the Moral Foundations of the Free Society," *Journal of Business Ethics* 1 (February 1982): 29–42; "Property Rights, Takings, and a Free Society," *Harvard Journal of Law and Public Policy* 6 (Summer 1983):165–95.

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THE PROSPECT OF REAL REFORM

Peter J. Ferrara

The Washington establishment, with President Reagan in tow, enacted into law in early 1983 a Social Security rescue plan that hurts everyone:

- The elderly will see their benefits cut through a delay in the cost-of-living adjustment (COLA) and the taxation of benefits;
- Workers will have their Social Security taxes increased even further, with the burden falling particularly harshly on the low- and middle-income workers who primarily pay the payroll tax;
- Today's young people will have their future expected rate of return under the program sharply slashed, particularly through the delay in the retirement age;
- Virtually every worker in the economy will be corralled into this insatiable program against his will; and
- For the first time, massive general-revenue subsidies will be infused into the program, smashing the principle of self-financing.

Yet, for all this pain and suffering, the bailout by the Washington establishment hardly even addresses the fundamental problems of Social Security.

It was, remarkably enough, less than five and a half years ago, in December 1977, that former president Carter led the enactment of another bailout plan to save a collapsing Social Security system. The plan involved the largest peacetime tax increase in U.S. history. In 1978, the Social Security Board of Trustees proclaimed in their annual report:

> The Social Security Amendments of 1977 ... restore the fiscal soundness of the cash benefit program throughout the remainder of this century and into the early years of the next one.[1]

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The author is an attorney with Shaw, Pittman, Potts, and Trowbridge, Washington, D.C. 20036. He was formerly senior staff member, Office of Policy Development, The White House.

[1]Social Security Board of Trustees, *1978 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, D.C., May 15, 1978), p. 3.

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Just two years later, the 1980 Annual Report said, in less sweeping and grandiose terms:

> Under all three sets of assumptions, . . . the assets of the OASI [Old-Age and Survivors Insurance] Trust Fund would soon become insufficient to pay benefits when due. . . . Accordingly, changes in the law are needed. . . .[2]

Now practically the same bureaucratic establishment has enacted another bailout plan based primarily on increased taxes and other palliatives that do not make any fundamental change in the program. We are again being assured that the system will be able to pay its benefits well into the next century.

Social Security's Continuing Problems

But the truth is that the program remains vulnerable to the cycles of inflation and recession that have plagued the American economy for the last 15 years. The Social Security Administration's own projections show that the program will have the same narrow margin for error for the rest of this decade that it had for the years immediately following the 1977 Carter bailout.[3] Even if we have strong economic growth over the next year, if sharp inflation returns in late 1984 or 1985, thereby accelerating indexed benefit expenditures, followed by a steep recession in late 1985 or 1986, shrinking payroll tax revenues, the program will probably collapse again before the end of the decade.

This is not a unique view. The Social Security Administration's deputy chief actuary in charge of the program's short-term projections had this to say in a briefing memorandum in early April:

> If actual growth is more rapid in 1983, but then restricted by another recession within the next few years, the trust funds could be in a worse financial position than indicated under [pessimistic assumptions]. . . . Depletion of the . . . trust funds would be very likely under these conditions and could conceivably occur within a few years from now.[4]

[2]Social Security Board of Trustees, *1980 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, D.C., June 17, 1980), p. 5.

[3]Richard S. Foster, "Short-Range Financial Status of the Social Security Program Under the Social Security Amendments of 1983," Social Security Administration, April 6, 1983; Social Security Board of Trustees, *1983 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, D.C., June 24, 1983).

[4]Foster, p. 3.

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This scenario merely follows a well-established pattern. It was the inflation of the early 1970s, followed by the 1974–75 recession, that caused the program to collapse in 1977. And it was the inflation of late 1970s, followed by the 1979–82 recessions, that caused the most recent collapse.

Even if another inflation/recession cycle does not develop so soon, the program will remain vulnerable. The establishment plan counts on massive tax increases in 1988 and 1990 to move the program out of the range of vulnerability. But these tax increases will not raise the expected revenue, because they will substantially harm the economy and lower employment. Other revenue items in the recently enacted bailout plan will also fail to meet expectations based on the official static estimates. Any remaining extra revenues will probably be drained off by the Hospital Insurance (HI) portion of the program, which is still projected to collapse by the end of the decade.[5]

The trust-fund assets for the entire program will therefore remain insufficient to see it through future inflation/recession cycles. Even if the program manages to stumble through one such cycle, it will not return to its former financial balance upon recovery. The trust funds will be permanently depleted to a lower level, and the program will collapse upon the development of a later cycle.

Thus, without the general monetary, budgetary, and tax reforms necessary to end these cycles permanently—and such reforms are not yet in prospect—Social Security will probably collapse again in a few years. The Washington establishment will then be back asking for more tax increases and more benefit cuts.

Having mandated that everyone depend on Social Security for the bulk of their retirement income, the leading policy gurus of establishment Washington should have been acutely embarrassed with the system collapsing twice in the last six years. They and their bureaucratic allies had been telling us for decades that such a collapse would never occur. But, instead, they and their devotees took to the countryside to terrorize the elderly they profess to champion. In one of the most shameful chapters in American political history, they sought during the 1982 campaign literally to scare the elderly into providing money and votes for them, telling of plans to slash dramatically, or even completely cut off, their Social Security benefits. These scare tactics were used when no one was even contemplating such cuts—not President Reagan, not his staff, not congressional Republicans, not even "conservative ideologues."

[5]Social Security Board of Trustees, *1983 Annual Report of the Board of Trustees of the Hospital Insurance Trust Fund* (Washington, D.C., June 29, 1983).

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In 1980, the president had campaigned on the pledge not to reduce benefits for existing beneficiaries, and he had fundamentally kept that pledge for two years. Nevertheless, establishment campaigners, with cynical and callous opportunism, used and abused the elderly for maximum short-term political advantage. In the end, these same people were the ones who successfully advanced the one item in the bailout plan that substantially cuts benefits for today's elderly—the taxation of benefits.

Social Security faces intractable long-term financing problems as well. Official projections showing financial balance over the long run are based on unreasonably optimistic assumptions.[6] The birth rate is assumed to increase substantially and permanently from current levels, even though the only period of fertility increase in U.S. history was produced by the back-to-back cataclysms of the Great Depression and World War II. The rate of increase in life expectancy is assumed to slow down significantly, even though we are entering a new technological age. The truly enormous deficit of the HI portion of the program is ignored. And no recessions or bouts of inflation are assumed for the next 75 years!

The truth is that paying the benefits promised to today's young workers will require payroll tax rates in the range of at least 25 to 30 percent, compared to 13 percent today. Former Social Security Chief Actuary A. Haeworth Robertson estimates that these tax rates may have to climb as high as 40 percent.[7]

Those who point with alarm at the long-term financing problems of the program are often accused of being irresponsible. But quite to the contrary, it is those who would induce today's young people to base their future on benefits that can never be paid who are irresponsible. There is nothing humane in covering up for a system that leaves the retirement security of an entire generation of Americans in serious financial jeopardy.[8]

The Burden on Young People

Nothing, however, more clearly indicates that Social Security is on its last legs than the fact that the rate of return paid by Social

[6]Social Security Board of Trustees, *1983 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.*

[7]See A. Haeworth Robertson, *The Coming Revolution in Social Security* (Reston, Va.: Reston Publishing Co., 1981). Robertson states that he still believes the tax rates may have to climb more than 40 percent, even with the latest bailout measures.

[8]For a more detailed discussion of the financing problem of Social Security, see Peter J. Ferrara, *Social Security: Averting the Crisis* (Washington, D.C.: Cato Institute, 1982), chap. 5.

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Security is falling steadily, and even if all the benefits promised to today's young workers are somehow paid, the program will still be a miserable deal for these workers. This development is a natural consequence of Social Security's pay-as-you-go method of financing—taxes paid by today's workers are not saved for their own benefits but are immediately paid out to finance the benefits of current beneficiaries.

Workers retiring in the early years of the program only had to pay taxes for part of their working careers. The tax burden in those years was also quite low. The maximum annual tax, including both the employer and employee shares, was $189 as late as 1958, and $348 as late as 1965. But because the program is run on a pay-as-you-go basis, the benefits paid to these early retirees were not limited to what could be paid based on their own taxes. These retirees were instead paid full benefits out of the taxes of those still working. Their benefits consequently represented a high return on the taxes they did pay.

Over time, the return began to fall, as workers began paying higher taxes for more of their working careers. For today's retirees, the program's benefits still represent a good return on the taxes they paid into the system. But those entering the work force today must pay taxes of several thousand dollars a year for their entire working careers. Today the maximum annual tax is almost $4,800 and will be almost $8,000 by the end of the decade. Moreover, the recently enacted rescue plan sharply cuts the benefits of younger workers, particularly through the delay in the retirement age. For most of these workers, the rate of return paid by Social Security will be 1 percent or less in real terms, even if they receive all the benefits they are currently promised. For many of these workers, the real return will be practically zero.

By contrast, if these workers could use their Social Security tax money to invest in private enterprises through an Individual Retirement Account (IRA), *most workers could count on receiving three to six times the benefits promised under Social Security*, and in some cases even more, depending on income and family size.[9] Now that the pay-as-you-go, start-up windfall is passing, this problem of inadequate returns will plague all future generations, and something must be done about it.

[9]For a more detailed discussion of the superiority of private invested alternatives for these workers, see Ferrara, *Social Security: Averting the Crisis*, chap. 5; Peter J. Ferrara, *Social Security: The Inherent Contradiction* (San Francisco: Cato Institute, 1980), chap. 4.

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The Burden on the Economy

Another major Social Security problem that must be addressed is the heavy burden of the payroll tax on the economy. To the extent that the tax is borne by employers, it discourages them from hiring. To the extent that the tax is borne by employees, it discourages them from working. The result is less employment and output. The payroll tax is no more than a tax on employment, and here as elsewhere, the result of taxing something is that there is less of it.

As noted, the maximum annual payroll tax is almost $4,800 today, and is projected to rise to almost $8,000 by the end of the decade. For at least half of all workers covered by Social Security, the combined payroll tax is more than they pay in federal income tax. In 1982, payroll tax revenues, drawn primarily from low- and moderate-income workers, were over 80 percent greater than total federal corporate and business tax revenues. In a society deeply concerned about employment opportunities, this incredible tax burden on the act of employment is ludicrous.[10]

There is also the problem of the negative impact of the program on savings. The needless and confused academic debate over this issue would profit greatly from a scintilla of reality. Apart from Social Security, most workers today are providing for their retirement through private savings vehicles. Given the modern American family and cultural attitudes, the practice of having numerous children to provide for one's support in retirement is long dead. But Social Security forces workers to provide for the bulk of their retirement income through a system that creates no savings. In essence, Social Security is a form of *forced nonsaving* for retirement. It is hardly even plausible to suggest that such a system does not today substantially reduce private savings.

In any event, this dispute can be left to the academics. The relevant issue for public policy analysis is what will happen in the future as a result of various reforms. If we shifted from Social Security's mandatory, pay-as-you-go system to a mandatory, private, fully funded system, then clearly there would be a significant increase in savings. And that is a strong point in favor of such a reform when deciding whether it should be adopted.[11]

Social Security suffers from other overwhelming problems, which cannot all be described in detail here. (a) The program's crazy-quilt

[10]For a more detailed discussion of the impact of the payroll tax on the economy, see Ferrara, *Social Security: Averting the Crisis*, chaps. 2 and 3.

[11]For a more detailed discussion of this issue, see Ferrara, *Social Security: Averting the Crisis*, chap. 3, and idem, *Social Security: The Inherent Contradiction*, chap. 3.

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benefit structure is haphazard and inequitable. (b) The structure includes many elements that can only be justified on a welfare rationale, yet the benefits paid through them go to too many who are not poor. (c) The program makes the retirement security of the elderly subject to the vagaries of politics. And (d) the program is harshly and unnecessarily coercive.[12]

It is easy to underestimate the vastness of the problems we are discussing. Social Security now accounts for more than one-fourth of the federal budget. Such overwhelming problems in such an enormous portion of our overgrown public sector cannot be ignored. These problems must be addressed. Social Security must be fundamentally reformed.

Toward Real Reform

The analytical key to this reform is to recognize that Social Security performs both insurance and welfare functions. It takes funds from everyone and returns benefits only when certain prestated contingencies occur–death, disability, sickness, retirement. Yet it provides additional benefits to those who are thought to be in need. The above-described problems can be solved by splitting these functions into two entirely separate programs or sets of institutions–allowing the welfare function to be performed by a separate program explicitly and carefully designed to help the poor, and allowing the insurance function to be performed by the private sector.[15]

We must also recognize that we cannot achieve our reform goals by cutting Social Security benefits. We can only solve the problems of Social Security by creating the means for most of the functions of the program to be performed in the private sector. Most of the program should be moved off the federal budget entirely. That will never be accomplished by attempting to cut benefits.

We must instead lead the way in protecting the benefits of the elderly against the Washington establishment, with its perpetually collapsing program. We must guarantee to the elderly that their benefits will not be cut. In a 1960 decision, *Flemming* v. *Nestor*, the Supreme Court held that Congress has the power to reduce or cut off Social Security benefits to any or all of the elderly at any time.[16]

[12]For a more detailed discussion of these problems, see Ferrara, *Social Security: Averting the Crisis*, chaps. 6–8, and idem, *Social Security: The Inherent Contradiction*, chaps. 6–8.

[15]See Ferrara, *Social Security: Averting the Crisis*, and idem, *Social Security: The Inherent Contradiction*.

[16]*Flemming* v. *Nestor*, 363 U.S. 603 (1960).

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The president and the Congress should make the statutory changes necessary to overturn this ruling.

At the time a worker retires in reliance on his future, promised Social Security benefits, he should receive a U.S. government bond contractually entitling him to those benefits. In accordance with an express congressional intent, this would give the retiree the same legal status as the holder of a U.S. Treasury bond. It would be unconstitutional for the government to refuse to repay such a bond holder. Similarly, it would be unconstitutional to cut the benefits of someone who had already retired on Social Security. Congress would retain authority to adjust benefits to future beneficiaries.

Second, IRAs must be expanded. The maximum annual contribution limit should be set equal to one-half the maximum annual combined Social Security tax. Nonworking spouses should be allowed to contribute the same amount as working spouses. IRA benefits should be made tax exempt, providing an immediate incentive for increased savings at virtually no cost now.

Third, the massive payroll tax increase now scheduled for 1988 and 1990 should be repealed. Neither workers nor the economy can afford these counterproductive increases.

Finally, and most important, workers must be allowed an opportunity to shift some and eventually all of their Social Security tax money into IRAs, in return for a commensurate reduction in their future Social Security benefits. There are many ways such an opportunity can be designed and implemented, and a choice among them is mainly strategic. Let us examine one plan that appears particularly attractive.

Starting on January 1, 1986, workers would be allowed to contribute to their IRAs each year, on top of any other amounts they may contribute, an additional amount up to 20 percent of their OASI taxes. They would be allowed a 100 percent *income tax credit* rather than the usual IRA deduction for these amounts. Workers could also direct their employers to contribute up to 20 percent of the employer share of the payroll tax to their IRAs, on top of any other contributions, with the employer again receiving a 100-percent income tax credit for this amount.

Workers would then have their future retirement benefits reduced to the extent they took advantage of this credit. A worker who opted for the full credit during his entire working career would have his retirement benefits reduced by 20 percent. A worker who regularly took half the credit each year would have his future benefits reduced by 10 percent. A worker who took half the credit for half his career would have his benefits reduced by 5 percent.

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The rationale behind the credit is to grant workers, in effect, a rebate of part of their Social Security taxes to the extent they reduce their reliance on Social Security and increase reliance on IRAs. But since the credit is taken against income rather than against payroll taxes, the revenue base of Social Security is left intact. Payroll taxes will continue to be fully and exclusively available to pay Social Security benefits. No general revenues need to be put into Social Security to assure that benefits continue to be paid.

The credit option will, however, reduce Social Security expenditures over time. More and more workers will be relying for more of their retirement benefits on private savings rather than Social Security. Since payroll tax revenues are held in place, one important effect of this credit option is to help close or eliminate any long-term funding gap in Social Security.

If everyone took full advantage of the credit option from the start, the income tax revenue loss in today's terms would be about $28 billion.[17] But if we assume more realistically that the credit option is only half-used across the population as a whole in the first year, which is probably still optimistic, the revenue loss would be about $14 billion.

Moreover, the increased investment through IRAs will result in increased revenues through the corporate income tax and other taxes. These new revenues, plus the reduced Social Security expenditures, will offset the revenue loss more and more over the years, eventually on net eliminating the loss entirely. Before this point, there will always be at least $1 in increased savings through IRAs for every $1 in lost revenue, because the income tax credit is only allowed for IRA savings.[18] So even if the federal deficit is temporarily increased by the full amount of this revenue loss, and this is surely not certain,

[17]This would be the cost of the reform if adopted today, as calculated from Social Security Board of Trustees, *1983 Annual Report of the Old-Age and Survivors Insurance and Disability Insurance Trust Funds*. The other estimates in this paper were calculated on the same basis.

[18]To avoid the danger of a mere shifting of existing savings into IRAs to obtain the credit, workers should be prohibited from withdrawing IRA amounts for which they obtained the credit and associated returns before retirement. (The assets would have to be appropriately segregated in the account for identification purposes.) This would make the IRA savings unsuitable as a substitute for nonretirement savings. Because Social Security benefits would be reduced for credited IRA contributions, the IRA savings would be needed to replace those lost benefits, and therefore would not be suitable as a substitute for other retirement savings either. As a result of these factors, any shifting of existing savings into IRAs, rather than new savings, to obtain the credit, should be negligible because such IRA savings will no longer be able to perform the function of other savings.

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there will still not be any increase on net in the government borrowing drain on private savings.

Starting on January 1, 1990, workers would be allowed to contribute additional amounts to their IRAs each year for the purchase of term life insurance, up to a maximum of 10 percent of their OASI taxes. Workers could also again direct their employers to contribute up to this amount for such purchases. Both employee and employer would receive an income tax credit equal to the amount of these contributions, instead of the usual IRA deduction.

An employee with no dependents would be allowed to contribute these additional amounts for his retirement. With one dependent, the employee would be allowed to contribute half these amounts for retirement.

Social Security currently pays survivors' benefits on behalf of a deceased taxpayer who leaves behind a wife and young children, or an elderly spouse. For those under 65, private, term life insurance can entirely perform this function. Consequently, a worker will have his pre-age-65 survivor's benefits reduced to the extent he took advantage of this credit during his career.

The income tax credit is again, in effect, a rebate of Social Security taxes for those who rely more on IRAs and less on Social Security. But again it leaves payroll-tax revenues intact and requires no use of general revenues to continue paying Social Security benefits.

If every worker took full advantage of the credit from the start, the revenue loss would be at most $14 billion in today's terms. But Social Security expenditures would also begin to decline fairly rapidly. There would not be any more new claims for pre-age-65 survivors' benefits, and once existing claims expire, these benefits would be phased out completely. All workers would then be relying on private life insurance for these benefits.

Moreover, there would be increased savings roughly equivalent to this revenue loss, as the life insurance companies would have to set aside the proceeds for each beneficiary in a lump sum. The increased investment resulting from these lump-sum proceeds would generate additional revenues. In conjunction with the reduced expenditures, such revenues would lead to the rapid net elimination of the revenue loss.

After these two steps, a substantial Social Security surplus can be expected by the mid-1990s. At that time, the maximum credit for IRA contributions could be increased to 30 percent or 40 percent, in return for further future Social Security benefit reductions. But the additional credit would be allowed against payroll-tax liabilities rather than income taxes, thus consuming the Social Security surplus.

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Consequently, there would be further expenditure reductions and another surplus in the future. The maximum credit could then be increased further until it reached 100 percent of OASI taxes. To accelerate this process, some of the additional credit increases could be allowed against income taxes, as in the first two steps, rather than against payroll taxes.

Workers could then be allowed to purchase disability and old-age health insurance through their IRAs, with further credits allowed for these purchases. Eventually, workers would have the opportunity to rely on IRAs entirely, in lieu of Social Security.

Such a reform would leave the Social Security framework fundamentally in place. Workers could choose to remain in Social Security if they desired. But the Social Security structure would be expanded to allow a role for the private sector. Workers would have the option to choose the combination of public and private alternatives they preferred. Those who have confidence in the free market, however, will recognize that virtually all workers will eventually opt for the private alternatives. There would continue to be a requirement that workers choose some vehicle for retirement and insurance protection.

The Supplemental Security Income program (SSI) would continue to provide special welfare benefits to the elderly or disabled poor, and would automatically grant benefits to those who had an inadequate retirement income from their IRAs and remaining Social Security. SSI could be adapted as part of this reform to ensure that it could perform this function adequately. But for those entering the work force today, even those who earn only the minimum wage throughout their working years would be able to earn substantially more through IRAs than through Social Security–enough to make supplemental welfare benefits unnecessary.

The Advantages of Reform

The possible benefits of such a reform are compelling. Today's young workers would be able to receive full market returns on the money they paid into IRAs. They would consequently be able to earn several times the benefits promised to them under Social Security. Mandated payments into IRAs could eventually be reduced, since workers need not be legally required to provide for such high retirement incomes. Regular take-home pay would therefore be increased for those still working.

The private IRA system will operate on a fully funded basis, with enough savings always on hand to finance earned benefits. Potential financing problems will therefore be solved, as much as they can

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ever be in this world. The bankruptcy crisis that still looms when today's young workers retire will be avoided.

Possibly hundreds of billions of dollars in increased savings will flow into the capital markets each year as a result of the increased savings through IRAs. Annual private savings could be almost doubled. Martin Feldstein, chairman of the Council of Economic Advisers, estimated during his academic days that Gross National Product (GNP) could as a result be increased by 20 percent.[19]

In the private IRA system, the numerous inequities that dominate the current Social Security benefit structure would be eliminated. Workers would be paid back what they paid in, plus interest. The waste of welfare benefits under the current system would also be eliminated, since welfare would only be paid through a means-tested system. Yet the poor would be taken care of.

With workers relying on the private sector for their benefits, total federal spending would be reduced by almost one-fourth, with total federal domestic spending (excluding defense and debt interest) reduced by almost one-half. Given that Social Security, national defense, and interest on the national debt amount to almost two-thirds of the federal budget, it is hard to imagine a substantial reduction in the federal government's claim on society without such a reform.

The reform would allow workers more control over their own incomes. They would be allowed to choose those investment vehicles that best meet their retirement and insurance needs. With each worker possibly developing a large estate through his own IRA, total national wealth would be distributed far more equally. Feldstein's calculations suggest that such a reform could reduce the concentration of national wealth by one-third.[20] Yet this would be achieved not by redistributing national wealth, but by providing an opportunity for the creation of new wealth, more equally distributed. Through the private IRA investments, each worker would be developing a substantial ownership stake in America's business and industry.

The reform would basically denationalize the large portion of the pension and insurance industries now operating in the public sector through Social Security. The public would characteristically be served better through the private sector and an enormous but unnecessary expansion of government would be cut back.

[19]Martin Feldstein, "Social Insurance," Harvard Institute of Economic Research, Discussion Paper 477, May 1976.

[20]Martin Feldstein, "Social Security and the Distribution of Wealth," *Journal of the American Statistical Association* 71 (December 1976): 800–807.

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Yet all this can be accomplished without in any way threatening the elderly. They would in fact be made much better off. Their benefits would be maintained, and indeed, constitutionally guaranteed. Political pressures to reduce these benefits will be diverted. At the same time, their children will have an opportunity for a more secure and prosperous retirement, and a chance to work in a healthy and growing economy now.

Such a reform is what the public wants in regard to Social Security. They want today's elderly to receive the present system's benefits. But at the same time the public, and especially today's young people, recognize that Social Security is not suited to the modern economy and today's workers. Individuals want expanded opportunity and control for the future. They will not long tolerate the periodic rounds of tax increases and benefit cuts and the "let them eat cake" mentality of the current Washington establishment.

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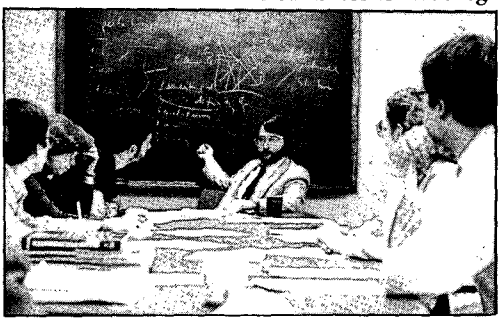

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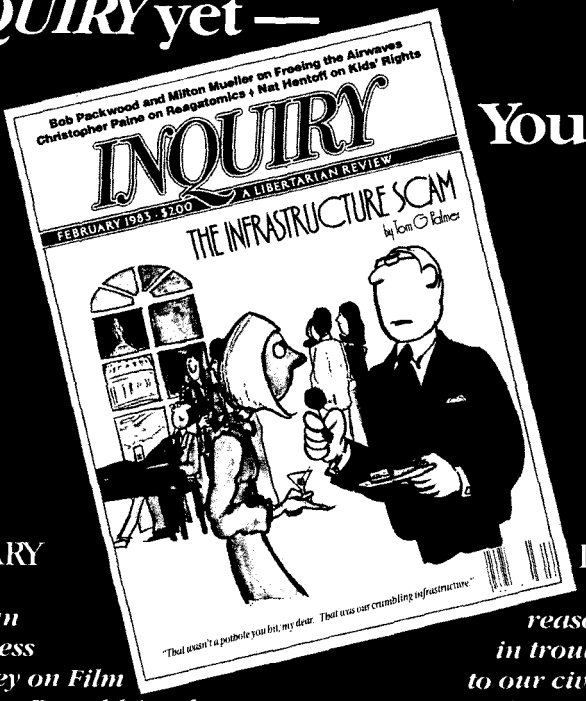
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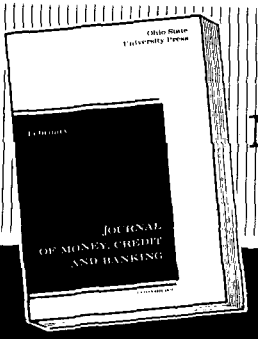

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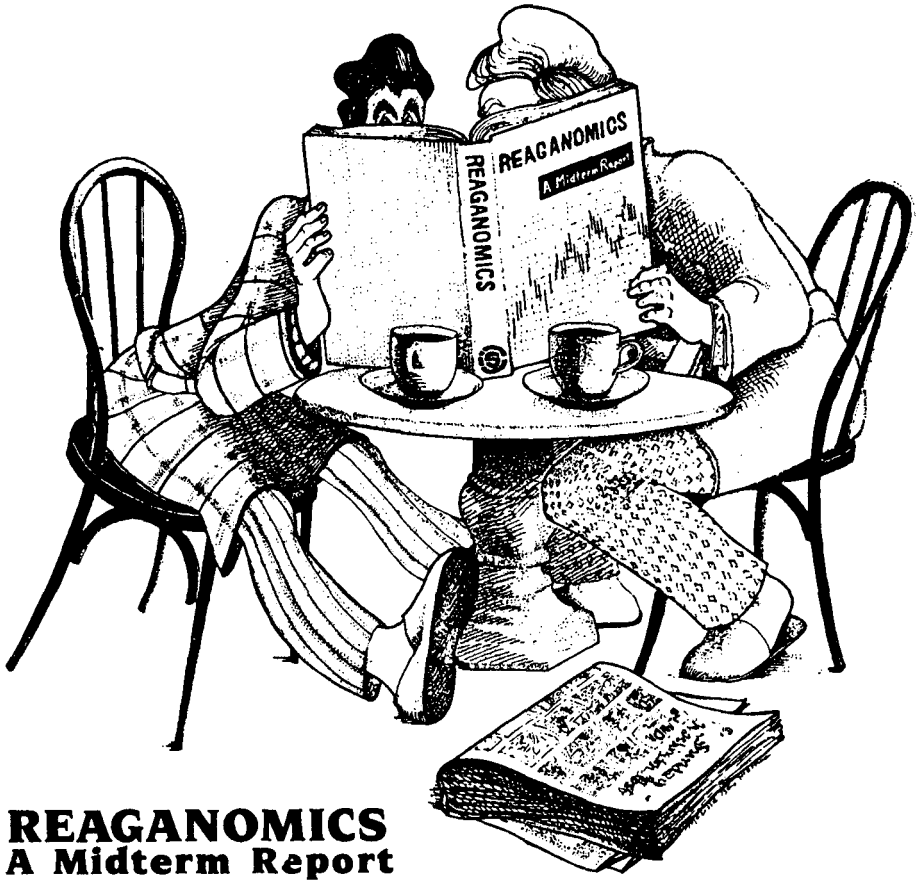

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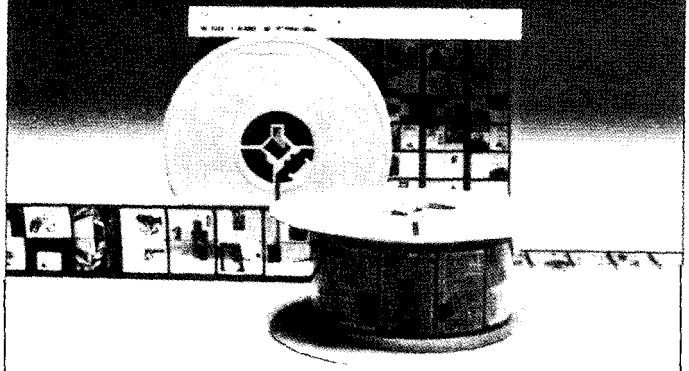

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—Carolyn L. Weaver

The Crisis in Social Security: Economic and Political Origins (Durham, N.C.: Duke University Press, 1982), pp. 189–90.

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